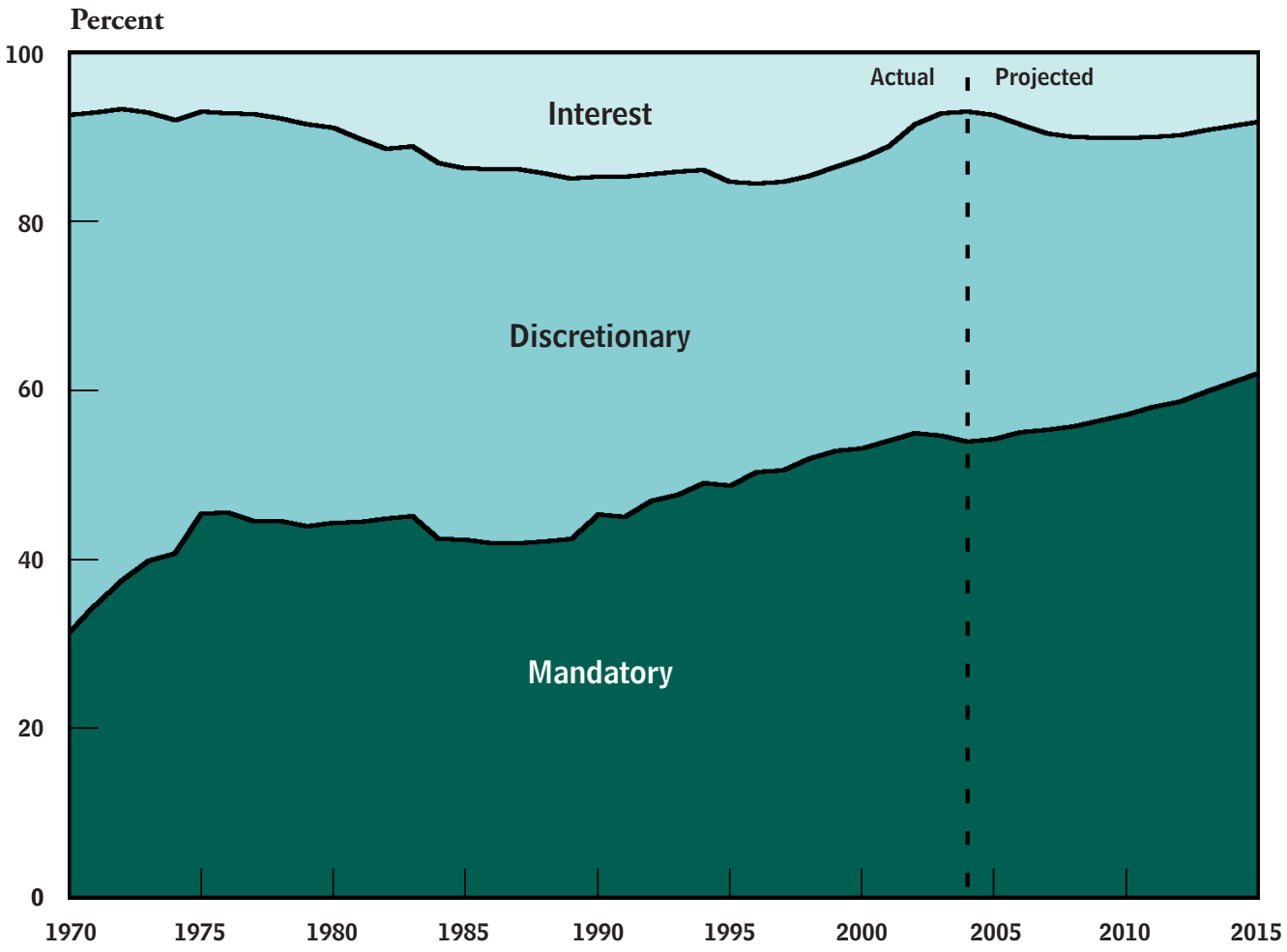
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

# The Budget and Economic Outlook: Fiscal Years 2006 to 2015

## Type of Spending as a Share of Total Outlays

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# The Budget and Economic Outlook: Fiscal Years 2006 to 2015

January 2005

The Congress of the United States ■ Congressional Budget Office

# Notes

Unless otherwise indicated, all years referred to in describing the economic outlook are calendar years; otherwise, the years are federal fiscal years (which run from October 1 to September 30).

Numbers in the text and tables may not add up to totals because of rounding.

Some of the figures in Chapter 2 and Appendix D use shaded vertical bars to indicate periods of recession. A recession extends from the peak of a business cycle to its trough.

Data for real (inflation-adjusted) gross domestic product are based on chained 2000 dollars.

# Preface

This volume is one of a series of reports on the state of the budget and the economy that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(e) of the Congressional Budget Act of 1974 for CBO to submit to the Committees on the Budget periodic reports about fiscal policy and to provide baseline projections of the federal budget. In accordance with CBO's mandate to provide impartial analysis, the report makes no recommendations.

The baseline spending projections were prepared by the staff of CBO's Budget Analysis Division under the supervision of Robert Sunshine, Peter Fontaine, Janet Airis, Thomas Bradley, Kim Cawley, Paul Cullinan, Jeffrey Holland, and Jo Ann Vines. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Thomas Woodward, Mark Booth, and David Weiner, with assistance from the Joint Committee on Taxation. (A detailed list of contributors to the spending and revenue projections appears in Appendix G.)

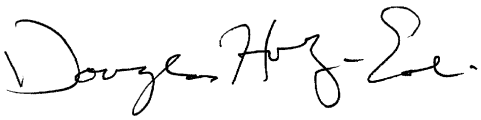
The economic outlook presented in Chapter 2 was prepared by the Macroeconomic Analysis Division under the direction of Robert Dennis. John F. Peterson, Robert Arnold, and Christopher Williams carried out the economic forecast and projections. David Brauer, Ufuk Demiroglu, Tracy Foertsch, Eva de Francisco, Douglas Hamilton, Juann Hung, Kim Kowalewski, Mark Lasky, Angelo Mascaro, Shinichi Nishiyama, Benjamin Page, Frank Russek, Robert Shackleton, and Sven Sinclair contributed to the analysis. Adam Gordon, Brian Mathis, and Amrita Palriwala provided research assistance.

CBO's Panel of Economic Advisers commented on an early version of the economic forecast underlying this report. Members of the panel are Andrew B. Abel, Alan Blinder, Dan Crippen, William C. Dudley, Martin Feldstein, Robert J. Gordon, Robert E. Hall, Robert Glenn Hubbard, Lawrence Katz, Catherine L. Mann, Allan H. Meltzer, Laurence H. Meyer, William D. Nordhaus, June E. O'Neill, Rudolph G. Penner, James Poterba, Robert Reischauer, and Alice Rivlin. Martin Baily, Nada Eissa, Paul Fronstin, and Casey Mulligan attended the panel's meeting as guests. Although CBO's outside advisers provided considerable assistance, they are not responsible for the contents of this report.

Jeffrey Holland wrote the summary. Barry Blom, Mark Booth, Ann Futrell, and Eric Schatten wrote Chapter 1 (David Newman wrote Box 1-1). Robert Arnold was the lead author for Chapter 2. Gerard Trimarco and Christina Hawley Sadoti authored Chapter 3, with assistance from Thomas Bradley and Eric Schatten. Mark Booth and Thomas Woodward were the lead authors for Chapter 4. Ellen Hays wrote Appendixes A and C; Frank Russek and Barry Blom, Appendix B; and David Brauer, Appendix D. Robert Arnold prepared Appendix E, and Ann Futrell compiled Appendix F. Jennifer Smith produced the glossary.

Christine Bogusz, Janey Cohen, Loretta Lettner, Leah Mazade, John Skeen, and Christian Spoor edited the report. Marion Curry, Linda Lewis Harris, and Denise Jordan-Williams

assisted in its preparation. Maureen Costantino designed the cover and prepared the report for publication. Lenny Skutnik and Carter Campbell printed the initial copies, and Annette Kalicki and Simone Thomas, with assistance from Martina Wojak-Piotrow, produced the electronic versions for CBO's Web site (www.cbo.gov).



Douglas Holtz-Eakin
Director

January 2005

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# Summary

The Congressional Budget Office (CBO) projects that if current laws and policies remained the same, the federal government would run budget deficits of $368 billion in 2005 and $295 billion in 2006 (see Summary Table 1). However, because of the statutory rules that govern such baseline projections, those estimates omit a significant amount of spending that will occur this year—and conceivably for some time in the future—for U.S. military operations in Iraq and Afghanistan and for other efforts in the war on terrorism.

Additional appropriations for such purposes are expected to add about $30 billion to the deficit this year and possibly more next year. Thus, the 2005 deficit is likely to total around $400 billion and the 2006 deficit well over $300 billion. With that extra spending included, the deficit in 2005 would amount to about 3.3 percent of gross domestic product (GDP)—compared with last year's deficit of 3.6 percent of GDP.

The absence of further appropriations for activities in Iraq and Afghanistan also masks a deterioration in budget projections over the 10 years in CBO's baseline. Since September 2004, when CBO last made projections,[1] the cumulative deficit projected for the 2005-2014 period (the 10 years covered by the previous baseline) has declined from $2.3 trillion to $1.4 trillion. However, following rules set forth in law, CBO's September baseline extrapolated supplemental funding for 2004—provided mostly for activities in Iraq and Afghanistan—throughout the 10-year period, thereby increasing projected outlays by more than $1.4 trillion (including the additional interest payments on federal debt). CBO's current baseline does not include appropriations for those activities because the funds have not been provided yet this year. If the baselines are made comparable by removing that extrapolation of supplemental funding from the preceding baseline, the outlook has actually become less favorable: the total deficit projected for the 2005-2014 period has grown by more than $500 billion, or 0.3 percent of GDP (see Summary Table 2). New legislation accounts for about three-quarters of that increase, most of it from recent laws that extend certain tax provisions and provide funding for disaster relief.

By statute, CBO's baseline projections must estimate the future paths of federal spending and revenues under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes.

Underlying CBO's baseline projections is a forecast that the U.S. economy will continue to grow at a healthy pace in 2005 and 2006. Although real (inflation-adjusted) GDP grew rapidly during the past two years, output remained considerably below the economy's potential. Therefore, by CBO's expectations, GDP will grow at an average annual rate of about 3.8 percent in the next two years to close most of that gap, before slowing to a pace of 2.9 percent for the 2007-2015 period.

Over the longer term, the federal budget will be strained significantly by demographic changes that will begin within the current 10-year projection period and intensify as members of the baby-boom generation age. In particular, the rising cost of health care will contribute to the growth of programs for elderly and low-income beneficiaries. As a result, under current law, total federal spending for Social Security, Medicare, and Medicaid is projected to grow by about 25 percent over the next 10 years relative to the size of the economy—from 8.4 percent of GDP in 2004 to 10.4 percent of GDP in 2015.

After 2015, if the growth of health care costs continues to exceed that of the economy, outlays for Social Security, Medicare, and Medicaid will claim an even larger share of federal spending as the percentage of the population age

1. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (September 2004).

**Summary Table 1.**

## CBO's Baseline Budget Outlook

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | In Billions of Dollars | | | | | | | |
| Total Revenues | 1,880 | 2,057 | 2,212 | 2,357 | 2,508 | 2,662 | 2,806 | 3,062 | 3,303 | 3,474 | 3,657 | 3,847 | 12,545 | 29,888 |
| Total Outlays | 2,292 | 2,425 | 2,507 | 2,618 | 2,743 | 2,869 | 2,996 | 3,142 | 3,232 | 3,389 | 3,542 | 3,706 | 13,733 | 30,743 |
| **Total Deficit (-) or Surplus** | **-412** | **-368** | **-295** | **-261** | **-235** | **-207** | **-189** | **-80** | **71** | **85** | **115** | **141** | **-1,188** | **-855** |
| On-budget | -567 | -541 | -484 | -471 | -464 | -453 | -451 | -357 | -217 | -212 | -190 | -169 | -2,323 | -3,469 |
| Off-budget[a] | 155 | 173 | 190 | 210 | 229 | 246 | 262 | 277 | 288 | 298 | 305 | 310 | 1,136 | 2,614 |
| Debt Held by the Public at the End of the Year | 4,296 | 4,665 | 4,971 | 5,246 | 5,494 | 5,716 | 5,919 | 6,012 | 5,955 | 5,884 | 5,784 | 5,658 | n.a. | n.a. |
| | | | | | | | As a Percentage of GDP | | | | | | | |
| Total Revenues | 16.3 | 16.8 | 17.2 | 17.3 | 17.5 | 17.7 | 17.8 | 18.6 | 19.2 | 19.3 | 19.4 | 19.6 | 17.5 | 18.5 |
| Total Outlays | 19.8 | 19.8 | 19.5 | 19.3 | 19.2 | 19.1 | 19.0 | 19.0 | 18.7 | 18.8 | 18.8 | 18.9 | 19.2 | 19.0 |
| **Total Deficit (-) or Surplus** | **-3.6** | **-3.0** | **-2.3** | **-1.9** | **-1.6** | **-1.4** | **-1.2** | **-0.5** | **0.4** | **0.5** | **0.6** | **0.7** | **-1.7** | **-0.5** |
| Debt Held by the Public at the End of the Year | 37.2 | 38.1 | 38.6 | 38.6 | 38.4 | 38.0 | 37.6 | 36.5 | 34.5 | 32.6 | 30.7 | 28.8 | n.a. | n.a. |
| **Memorandum:** | | | | | | | | | | | | | | |
| Gross Domestic Product (Billions of dollars) | 11,553 | 12,233 | 12,888 | 13,586 | 14,307 | 15,029 | 15,757 | 16,494 | 17,245 | 18,023 | 18,826 | 19,652 | 71,566 | 161,806 |

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

65 or older continues to rise (from 14 percent in 2015 to 19 percent in 2030). Thus, over the long term, the increasing resources needed for such programs will exert pressure on the federal budget that will make current fiscal policy unsustainable.

## The Budget Outlook

Under the assumption that current laws and policies remain unchanged, CBO projects that federal deficits will begin to decline this year. In CBO's baseline, deficits drop as a percentage of GDP, from the 3.6 percent recorded in 2004 to 1.2 percent in 2010. Beginning in 2012—if taxes increased as scheduled under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), discretionary spending continued to grow no faster than inflation, and other policies stayed the same—the budget would shift to small annual surpluses.

Over the 2005-2015 period, outlays are projected to grow at an average annual rate of 4.3 percent and to gradually diminish from 19.8 percent of GDP this year to 18.9 percent in 2015 (see Summary Figure 1). That downward drift of total outlays as a percentage of GDP is driven by the treatment of discretionary spending under rules set forth in law. CBO projects growth in discretionary spending as specified in the Balanced Budget and Emergency Deficit Control Act of 1985 (using the GDP deflator and the employment cost index for wages and salaries). The combined rate of growth of those factors is about half of that projected for nominal GDP. As a result, CBO's baseline projection for discretionary outlays falls from 7.6 percent of GDP in 2005 to 5.6 percent in 2015. Including future costs for activities in Iraq and Afghanistan (and for other such activities) would probably not affect that trend significantly.

**Summary Table 2.**

## Changes Since September 2004 in CBO's Estimate of the Cumulative Deficit for 2005 to 2014

(Billions of dollars)

| | 10-Year Total |
|---|---|
| September 2004 | |
| Projected deficit | -2,294 |
| Less the effect of extending supplemental appropriations for 2004 | 1,433 |
| Adjusted projected deficit | -861 |
| Other Changes to the Baseline Since September 2004 | |
| Legislative | -371 |
| Economic | 41 |
| Technical | -173 |
| **Total** | **-504** |
| January 2005 | |
| Projected deficit | -1,364 |

Source: Congressional Budget Office.

Note: According to rules set forth in law, CBO's September 2004 baseline extrapolated through 2014 supplemental appropriations of $115 billion provided in 2004 (mostly for operations in Iraq and Afghanistan). CBO's January 2005 baseline does not include appropriations for those operations because the funds have not been provided yet this year. Hence, for the purpose of making a consistent comparison between the September 2004 and January 2005 baselines, this table removes the extension of such supplemental appropriations from the previous baseline. The 10-year totals include changes in projected debt-service costs (interest payments on federal debt) resulting from projected changes in the government's borrowing.

Negative numbers in this table represent deficits or increases to deficits.

In the current baseline, which covers 2006 through 2015, the cumulative deficit totals $855 billion.

Mandatory spending continues to account for a rising share of federal outlays; such spending is projected to grow from 54 percent of total outlays in 2004 to 62 percent in 2015 (see Summary Figure 2). Under the assumption that no changes in policy take place, spending for mandatory programs is projected to grow by 5.7 percent a year—faster than the rate projected for the economy as a whole. Such growth is driven largely by outlays for Medicare and Medicaid, which are projected to rise at average annual rates of 9.0 percent and 7.8 percent, respectively, through 2015. By the middle of the projection period, Social Security spending is also expected to grow faster than the economy, as the baby-boom generation begins to collect benefits.

Revenues are projected to total 16.8 percent of GDP this year—nearly 1.5 percentage points below the average since 1962 (18.2 percent). Over the coming decade, revenues are expected to continue increasing, growing faster than GDP in every year of the projection period. That ascent is driven by the structure of the tax system, which causes revenues to claim a higher fraction of income in taxes every year as income grows. In addition, a large boost in revenues occurs in CBO's baseline after the major provisions of EGTRRA expire at the end of 2010. By 2015, such receipts are projected to reach 19.6 percent of GDP.

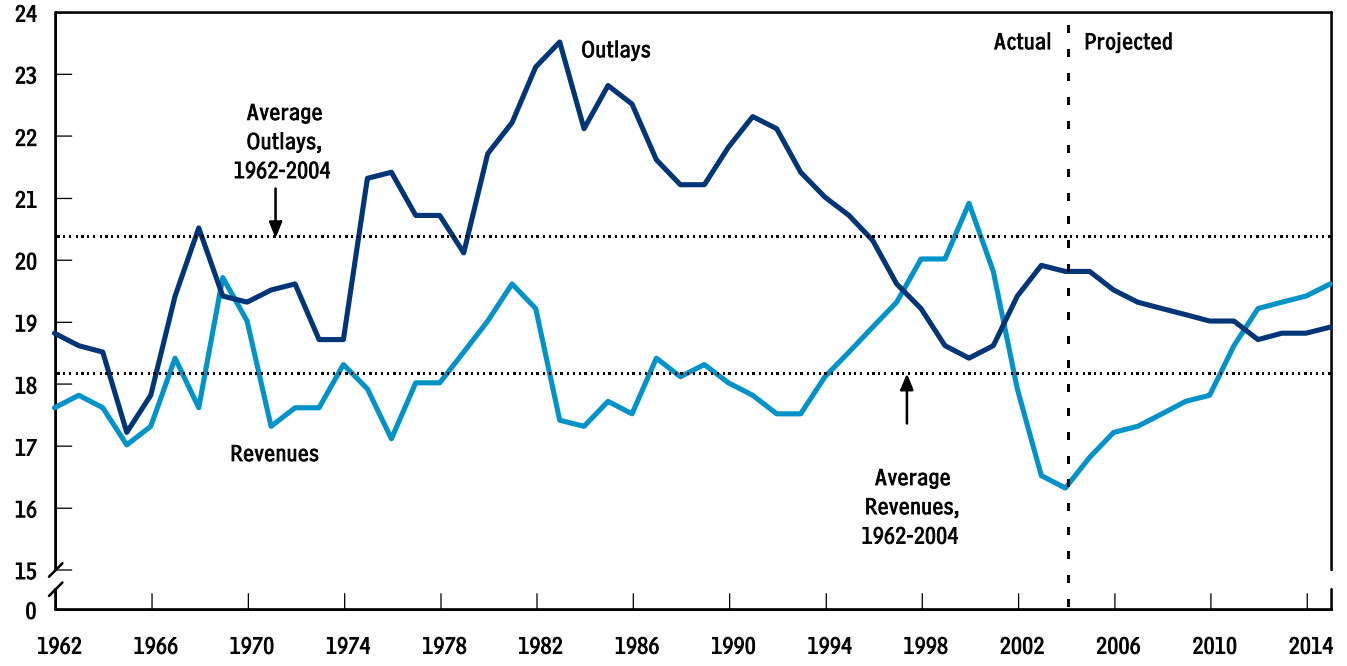
Debt held by the public (the most meaningful measure of federal debt in terms of its relationship to the economy) is anticipated to equal 38.1 percent of GDP at the end of this fiscal year. In CBO's baseline, that debt stabilizes at around its current level of GDP through 2010, at which point the federal government's diminished need to borrow reduces the growth of such debt.

Since September, when CBO issued its previous baseline, changes unrelated to the treatment of spending for activities in Iraq and Afghanistan have increased the cumulative deficit projected for 2005 to 2014 by more than $500 billion. Among the legislation that contributed to that increase was the Working Families Tax Relief Act of 2004. That law extended several tax provisions, including the 10 percent tax bracket, relief from the marriage penalty, and the increase in the child tax credit—thereby adding $146 billion to the 10-year deficit (excluding debt-service costs). In addition, supplemental appropriations for 2005 provide $11.5 billion in disaster relief for hurricane victims; extrapolating that budget authority through 2014 (following rules for the baseline) adds $94 billion to discretionary spending. Revisions to the baseline caused by changes in CBO's economic forecast were fairly small, reducing the projected 10-year deficit by $41 billion. Other, so-called technical revisions to the baseline—mostly involving revenues—increased that cumulative deficit by $173 billion.

**Summary Figure 1.**

## Total Revenues and Outlays as a Percentage of GDP, 1962 to 2015

(Percentage of GDP)




Source: Congressional Budget Office.

## The Economic Outlook

According to CBO's forecast, in 2005 and 2006, the U.S. economy continues to grow at a healthy pace. Although investment by businesses is not expected to grow as rapidly as in 2004, such spending will probably still lead the economy's continuing expansion. Moreover, the caution that has characterized firms' decisions over the past three years appears to be dissipating, and businesses seem to be having greater difficulty meeting increases in demand with their current workforce; as a result, hiring should accelerate. Growth of productivity, which has been exceptionally strong since 2001, is expected to slow relative to its rate in the recent past but to continue at a pace similar to the long-run average. Thus, CBO expects that real GDP will grow by 3.8 percent in calendar year 2005 and 3.7 percent in 2006, before slowing to a pace of 2.9 percent for the 2007-2015 period (see Summary Table 3).

The rate of unemployment is forecast to decline from 5.4 percent at the end of 2004 to 5.2 percent in 2005 and 2006. During the 2007-2015 period, the rate of unemployment is expected to average 5.2 percent.

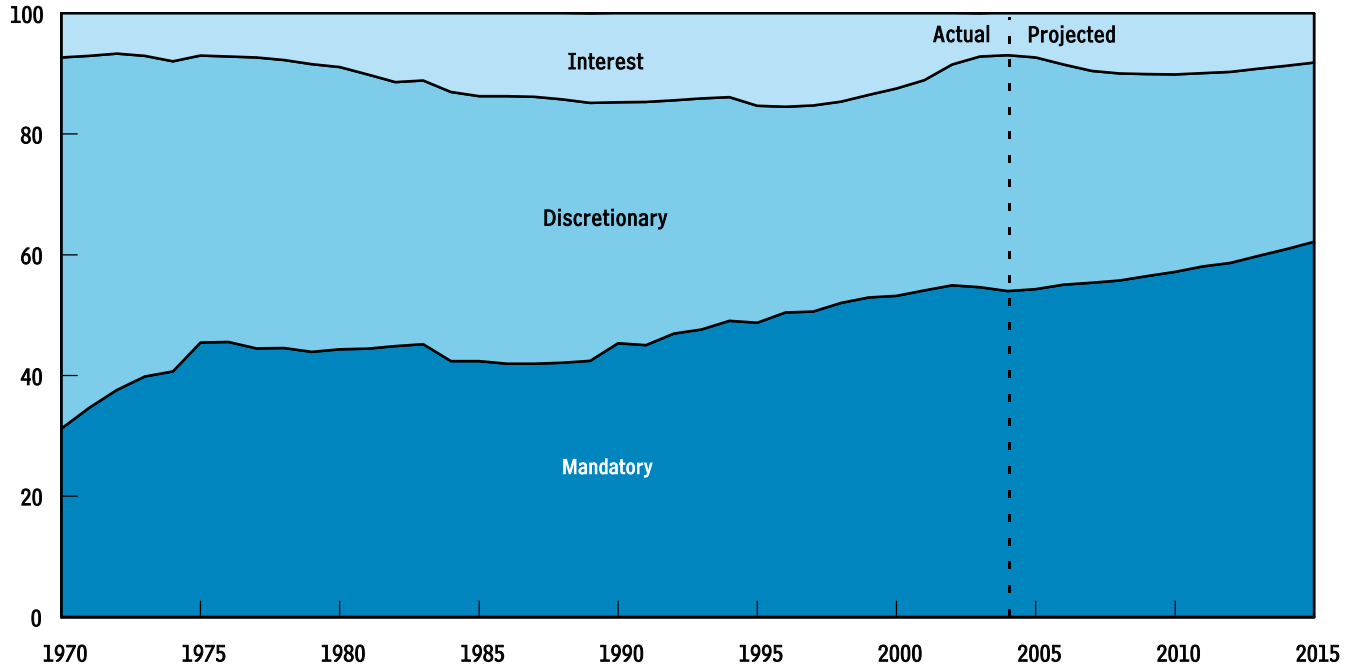
According to CBO's forecast, inflation is lower in 2005 and 2006 than in 2004. A surge in energy prices, along with an acceleration in the cost of shelter and in used car prices, caused a spike in inflation in 2004, as measured by the consumer price index for all urban consumers. That increase is not expected to feed into core inflation (inflation excluding changes in prices for food and energy). CBO projects that consumer prices will rise by 2.4 percent in 2005 and 1.9 percent in 2006; during the 2007-2015 period, CBO anticipates growth averaging 2.2 percent.

Interest rates are expected to move upward during the next two years, as the economy grows and the Federal Reserve continues to move toward a more neutral monetary policy. CBO forecasts that the three-month Treasury bill rate will rise to about 2.8 percent in 2005 and 4 percent in 2006; thereafter, it will average 4.6 percent, which is relatively low by historical standards. In the forecast, the rise in the rate for the 10-year Treasury note is somewhat smaller; it averages 4.8 percent in 2005 and 5.4 percent in 2006, then inches up to average 5.5 percent from 2007 to 2015.

**Summary Figure 2.**

## Type of Spending as a Share of Total Outlays, 1970 to 2015

(Percent)




Source: Congressional Budget Office.

**Summary Table 3.**

## CBO's Economic Projections for Calendar Years 2005 to 2015

| | Estimated | Forecast | | Projected Annual Average | |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007-2010 | 2011-2015 |
| Nominal GDP (Billions of dollars) | 11,730 | 12,396 | 13,059 | 15,940 [a] | 19,861 [b] |
| Nominal GDP (Percentage change) | 6.6 | 5.7 | 5.3 | 5.1 | 4.5 |
| Real GDP (Percentage change) | 4.4 | 3.8 | 3.7 | 3.3 | 2.7 |
| GDP Price Index (Percentage change) | 2.1 | 1.8 | 1.5 | 1.8 | 1.8 |
| Consumer Price Index[c] (Percentage change) | 2.7 | 2.4 | 1.9 | 2.2 | 2.2 |
| Unemployment Rate (Percent) | 5.5 | 5.2 | 5.2 | 5.2 | 5.2 |
| Three-Month Treasury Bill Rate (Percent) | 1.4 | 2.8 | 4.0 | 4.6 | 4.6 |
| Ten-Year Treasury Note Rate (Percent) | 4.3 | 4.8 | 5.4 | 5.5 | 5.5 |

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

a. Level in 2010.

b. Level in 2015.

c. The consumer price index for all urban consumers.

CHAPTER

# 1

# The Budget Outlook

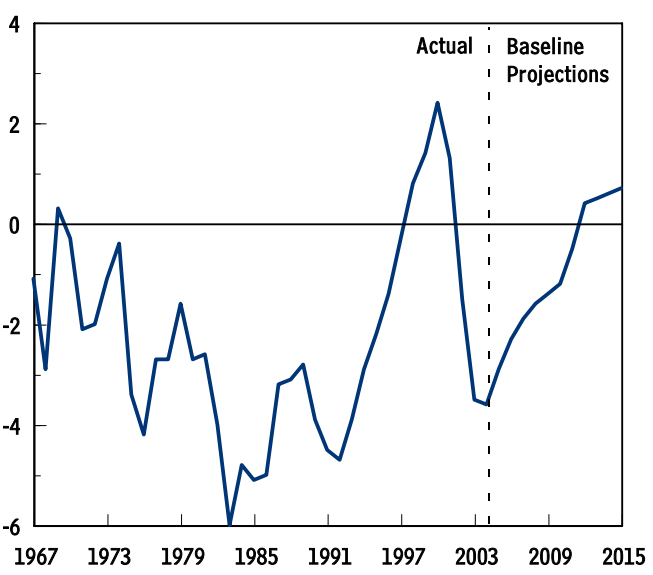
The Congressional Budget Office's (CBO's) new baseline projections indicate that if current laws and policies did not change, the federal budget would run a deficit of $368 billion in 2005 and a smaller deficit, $295 billion, next year. After that, annual deficits would gradually decline, turning into a small surplus by 2012, assuming that various tax increases occurred as scheduled. Relative to the size of the economy, the deficit would equal 3.0 percent of the nation's gross domestic product (GDP) this year and 2.3 percent of GDP in 2006. By 2015, the end of CBO's 10-year projection period, the baseline surplus would equal 0.7 percent of GDP (see Figure 1-1).

At first glance, the current baseline budget outlook may appear to have improved relative to CBO's previous projections, which were issued last September.[1] The cumulative deficit projected for the 2005-2014 period (the 10 years covered by the previous baseline) has declined from $2.3 trillion to $1.4 trillion. However, because of the statutory rules that govern baseline projections, the current baseline omits a significant amount of spending that will occur this year—and possibly for some time to come—for U.S. military operations in Iraq and Afghanistan and for other activities related to the global war on terrorism. Likewise, those rules may have led the September 2004 baseline to overstate such costs.

Under the Balanced Budget and Emergency Deficit Control Act of 1985, discretionary spending (spending controlled by annual appropriation acts) is projected by assuming that the most recent year's funding is continued in each subsequent year with adjustments for projected inflation. In 2004, supplemental appropriations provided $115 billion for operations in Iraq and Afghanistan (and for other activities); in CBO's September baseline, that sum was extrapolated for each future year.[2] But so far in 2005, no appropriations have been provided for those operations. As a result, unlike the preceding projections, the

**Figure 1-1.**

## The Total Deficit or Surplus as a Percentage of GDP, 1967 to 2015




Source: Congressional Budget Office.

1. Those projections were published in Congressional Budget Office, *The Budget and Economic Outlook: An Update* (September 2004).

2. That $115 billion, which included a small amount of funding unrelated to activities in Iraq and Afghanistan, comprised funding from two laws that provided supplemental appropriations for 2004. The first, enacted in November 2003, provided $87 billion. The second, the Department of Defense Appropriations Act, 2005, provided another $28 billion for 2004 (including $1.8 billion from reversing a rescission that had previously been enacted but not yet applied). In addition, $2 billion in supplemental funding for hurricane relief was provided in September, after CBO published its baseline.

**Table 1-1.**

## Comparison of CBO's January 2005 and September 2004 Baseline Deficits or Surpluses

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Total, 2005-2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Baseline Deficit (-) or Surplus as Projected in January 2005[a] | -368 | -295 | -261 | -235 | -207 | -189 | -80 | 71 | 85 | 115 | -1,364 |
| Deficit (-) or Surplus as Projected in September 2004 and Adjusted to Exclude the Extension of Supplemental Appropriations[b] | -310 | -202 | -187 | -183 | -166 | -142 | -32 | 108 | 115 | 138 | -861 |
| **Memorandum:** | | | | | | | | | | | |
| Baseline Deficit as Projected in September 2004[b] | -348 | -298 | -308 | -318 | -312 | -298 | -200 | -70 | -75 | -65 | -2,294 |

Source: Congressional Budget Office.

a. Does not include additional funding for operations in Iraq and Afghanistan, which has not yet been requested for 2005.

b. CBO's September 2004 baseline extrapolated $115 billion in supplemental funding (mostly for activities in Iraq and Afghanistan) throughout the 2005-2014 period. Excluding the extension of such funding reduces outlays over that period by $1.4 trillion (including debt-service costs).

current baseline includes only outlays for such activities that result from appropriations enacted for previous years.

Once further appropriations for those operations are provided, they are likely to add about $30 billion to the deficit this year and possibly more next year. (For a discussion of one plausible path for future spending on military operations in Iraq and Afghanistan and the global war on terrorism, see page 9.) Thus, the 2005 deficit is likely to total around $400 billion and the 2006 deficit well over $300 billion. With that extra spending for military operations included, the 2005 deficit would amount to about 3.3 percent of GDP—compared with the deficit in 2004 of 3.6 percent of GDP.

Under identical assumptions about spending on Iraq, Afghanistan, and other activities related to the war on terrorism, the current baseline outlook is less favorable than the one presented in September: the total deficit projected for the 2005-2014 period has grown from $861 billion to $1.3 trillion—a rise of more than $500 billion, or 0.3 percent of GDP (see Table 1-1). A number of factors account for that increase. The Working Families Tax Relief Act of 2004 (WFTRA)—which extended several tax provisions, including the 10 percent tax bracket, marriage-penalty relief, and the increase in the child tax credit—added $146 billion to the 10-year deficit, mostly by decreasing projected revenues.[3] In addition, supplemental appropriations for 2005 provide $11.5 billion in disaster relief for hurricane victims; extrapolating that budget authority through 2014 added $94 billion to projected discretionary outlays. Revisions to the baseline caused by changes in CBO's economic forecast were fairly small, reducing the cumulative deficit by $41 billion. Other, technical revisions to the baseline—mostly involving revenues—had a greater effect on the 10-year deficit, increasing it by $173 billion.

In the current baseline, total outlays grow at an average rate of 4.3 percent a year and remain around 19 percent to 20 percent of GDP through 2015 (see Table 1-2). Within that total, mandatory spending (funding determined by laws other than annual appropriation acts) is projected to grow by 5.7 percent a year—faster than the

3. That estimate excludes additional debt-service costs (interest payments on federal debt) that result from the increase in projected deficits.

## Table 1-2.

# CBO's Baseline Budget Projections

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | In Billions of Dollars | | | | | | | |
| Revenues | | | | | | | | | | | | | | |
| Individual income taxes | 809 | 899 | 986 | 1,082 | 1,172 | 1,265 | 1,362 | 1,561 | 1,718 | 1,822 | 1,932 | 2,048 | 5,867 | 14,947 |
| Corporate income taxes | 189 | 216 | 226 | 226 | 237 | 246 | 249 | 254 | 261 | 270 | 281 | 292 | 1,184 | 2,542 |
| Social insurance taxes | 733 | 790 | 833 | 876 | 918 | 962 | 1,009 | 1,054 | 1,102 | 1,151 | 1,202 | 1,253 | 4,598 | 10,360 |
| Other | 148 | 153 | 167 | 173 | 181 | 188 | 187 | 192 | 221 | 231 | 243 | 255 | 896 | 2,038 |
| **Total** | **1,880** | **2,057** | **2,212** | **2,357** | **2,508** | **2,662** | **2,806** | **3,062** | **3,303** | **3,474** | **3,657** | **3,847** | **12,545** | **29,888** |
| On-budget | 1,345 | 1,484 | 1,607 | 1,719 | 1,836 | 1,956 | 2,066 | 2,287 | 2,494 | 2,629 | 2,775 | 2,928 | 9,184 | 22,297 |
| Off-budget | 535 | 573 | 605 | 638 | 672 | 706 | 740 | 774 | 809 | 845 | 882 | 919 | 3,361 | 7,591 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary spending | 895 | 930 | 914 | 919 | 940 | 959 | 980 | 1,006 | 1,022 | 1,050 | 1,075 | 1,101 | 4,713 | 9,966 |
| Mandatory spending | 1,237 | 1,317 | 1,380 | 1,450 | 1,529 | 1,620 | 1,713 | 1,824 | 1,896 | 2,028 | 2,159 | 2,303 | 7,692 | 17,902 |
| Net interest | 160 | 178 | 213 | 249 | 274 | 289 | 303 | 311 | 314 | 311 | 308 | 303 | 1,328 | 2,875 |
| **Total** | **2,292** | **2,425** | **2,507** | **2,618** | **2,743** | **2,869** | **2,996** | **3,142** | **3,232** | **3,389** | **3,542** | **3,706** | **13,733** | **30,743** |
| On-budget | 1,913 | 2,024 | 2,092 | 2,190 | 2,300 | 2,409 | 2,517 | 2,644 | 2,711 | 2,841 | 2,965 | 3,097 | 11,508 | 25,766 |
| Off-budget | 380 | 401 | 415 | 428 | 443 | 460 | 479 | 497 | 521 | 548 | 577 | 609 | 2,225 | 4,977 |
| **Deficit (-) or Surplus** | **-412** | **-368** | **-295** | **-261** | **-235** | **-207** | **-189** | **-80** | **71** | **85** | **115** | **141** | **-1,188** | **-855** |
| On-budget | -567 | -541 | -484 | -471 | -464 | -454 | -451 | -357 | -217 | -212 | -190 | -169 | -2,324 | -3,469 |
| Off-budget | 155 | 173 | 190 | 210 | 229 | 246 | 262 | 277 | 289 | 298 | 305 | 310 | 1,136 | 2,614 |
| Debt Held by the Public | 4,296 | 4,665 | 4,971 | 5,246 | 5,494 | 5,716 | 5,919 | 6,012 | 5,955 | 5,884 | 5,784 | 5,658 | n.a. | n.a. |
| **Memorandum:** | | | | | | | | | | | | | | |
| Gross Domestic Product | 11,553 | 12,233 | 12,888 | 13,586 | 14,307 | 15,029 | 15,757 | 16,494 | 17,245 | 18,023 | 18,826 | 19,652 | 71,566 | 161,806 |
| | | | | | | | As a Percentage of GDP | | | | | | | |
| Revenues | | | | | | | | | | | | | | |
| Individual income taxes | 7.0 | 7.3 | 7.7 | 8.0 | 8.2 | 8.4 | 8.6 | 9.5 | 10.0 | 10.1 | 10.3 | 10.4 | 8.2 | 9.2 |
| Corporate income taxes | 1.6 | 1.8 | 1.8 | 1.7 | 1.7 | 1.6 | 1.6 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.7 | 1.6 |
| Social insurance taxes | 6.3 | 6.5 | 6.5 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 |
| Other | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.2 | 1.2 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| **Total** | **16.3** | **16.8** | **17.2** | **17.3** | **17.5** | **17.7** | **17.8** | **18.6** | **19.2** | **19.3** | **19.4** | **19.6** | **17.5** | **18.5** |
| On-budget | 11.6 | 12.1 | 12.5 | 12.7 | 12.8 | 13.0 | 13.1 | 13.9 | 14.5 | 14.6 | 14.7 | 14.9 | 12.8 | 13.8 |
| Off-budget | 4.6 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 |
| Outlays | | | | | | | | | | | | | | |
| Discretionary spending | 7.7 | 7.6 | 7.1 | 6.8 | 6.6 | 6.4 | 6.2 | 6.1 | 5.9 | 5.8 | 5.7 | 5.6 | 6.6 | 6.2 |
| Mandatory spending | 10.7 | 10.8 | 10.7 | 10.7 | 10.7 | 10.8 | 10.9 | 11.1 | 11.0 | 11.3 | 11.5 | 11.7 | 10.7 | 11.1 |
| Net interest | 1.4 | 1.5 | 1.7 | 1.8 | 1.9 | 1.9 | 1.9 | 1.9 | 1.8 | 1.7 | 1.6 | 1.5 | 1.9 | 1.8 |
| **Total** | **19.8** | **19.8** | **19.5** | **19.3** | **19.2** | **19.1** | **19.0** | **19.0** | **18.7** | **18.8** | **18.8** | **18.9** | **19.2** | **19.0** |
| On-budget | 16.6 | 16.5 | 16.2 | 16.1 | 16.1 | 16.0 | 16.0 | 16.0 | 15.7 | 15.8 | 15.8 | 15.8 | 16.1 | 15.9 |
| Off-budget | 3.3 | 3.3 | 3.2 | 3.2 | 3.1 | 3.1 | 3.0 | 3.0 | 3.0 | 3.0 | 3.1 | 3.1 | 3.1 | 3.1 |
| **Deficit (-) or Surplus** | **-3.6** | **-3.0** | **-2.3** | **-1.9** | **-1.6** | **-1.4** | **-1.2** | **-0.5** | **0.4** | **0.5** | **0.6** | **0.7** | **-1.7** | **-0.5** |
| On-budget | -4.9 | -4.4 | -3.8 | -3.5 | -3.2 | -3.0 | -2.9 | -2.2 | -1.3 | -1.2 | -1.0 | -0.9 | -3.2 | -2.1 |
| Off-budget | 1.3 | 1.4 | 1.5 | 1.5 | 1.6 | 1.6 | 1.7 | 1.7 | 1.7 | 1.7 | 1.6 | 1.6 | 1.6 | 1.6 |
| Debt Held by the Public | 37.2 | 38.1 | 38.6 | 38.6 | 38.4 | 38.0 | 37.6 | 36.5 | 34.5 | 32.6 | 30.7 | 28.8 | n.a. | n.a. |

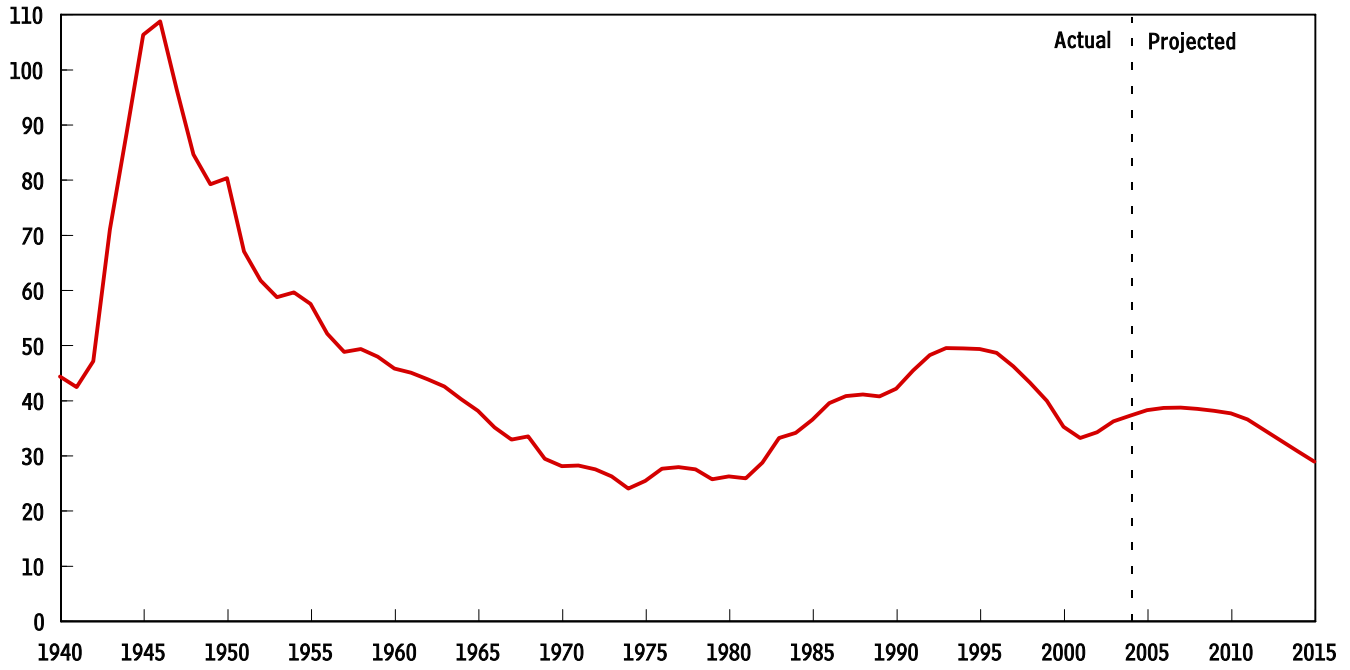
Source: Congressional Budget Office.

Note: n.a. = not applicable.

**Figure 1-2.**

## Debt Held by the Public as a Percentage of GDP, 1940 to 2015

(Percent)




Source: Congressional Budget Office.

economy as a whole. Discretionary appropriations, by contrast, are assumed simply to keep pace with inflation and, to a lesser extent, with wage growth. As explained above, however, the baseline does not include additional funding for military operations in Iraq and Afghanistan and for the global war on terrorism; thus, discretionary outlays are projected to increase by only 1.7 percent a year, on average, from the baseline level for 2005.

For revenues, CBO assumes—as baseline rules require—that the various tax provisions enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and modified by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and by WFTRA will expire as scheduled on December 31, 2010. As a result, revenues as a percentage of GDP are projected to rise slowly through 2010, from 16.8 percent to 17.8 percent, and then increase more rapidly in 2011 and 2012, reaching 19.6 percent of GDP by 2015.

Accumulated federal debt held by the public (mainly in the form of Treasury bonds) equals about 38 percent of GDP through 2010 in CBO's baseline. Thereafter, projections of shrinking annual deficits diminish the government's need to borrow, causing debt held by the public to decline to less than 29 percent of GDP by 2015 (see Figure 1-2).

Although the baseline projections are prohibited from incorporating anticipated policy changes, this chapter shows the budgetary implications of some alternative policy assumptions over the next 10 years. For example, if military operations in Iraq and Afghanistan and other activities related to the global war on terrorism were assumed to continue (but slow gradually) for the next few years rather than being excluded from the baseline altogether, the total deficit projected for the 2006-2015 period would increase from $855 billion to $1.4 trillion. Debt held by the public at the end of 2015 would equal almost 32 percent of GDP instead of less than 29 percent.

Similarly, if all of the tax provisions that are set to expire over the next 10 years (except for one related to the alternative minimum tax) were extended, the budget outlook for 2015 would change from a surplus of $141 billion to

a deficit of $282 billion.[4] Debt held by the public at the end of 2015 would equal 38 percent of GDP, and the 10-year deficit would total $2.7 trillion.

Over the longer term, demographic changes will put significant strains on the federal budget. Those strains are set to begin within the current 10-year projection period and intensify as members of the baby-boom generation age. In addition, the cost of health care for the elderly is likely to keep growing rapidly. As a result, the annual growth rate of Medicare spending is projected to increase from 6.2 percent in 2008 (after the prescription drug benefit has been fully phased in) to 8.3 percent in 2015. Spending for Medicaid also is estimated to grow by more than 8 percent a year at the end of the projection period. The annual growth of Social Security spending is expected to accelerate from around 4.5 percent in 2006 to 6.4 percent in 2015. Under baseline assumptions, those three programs together will account for 55 percent of all federal spending by 2015, up from 42 percent this year.

After 2015, as the percentage of the population age 65 or older continues to increase (from 14 percent in 2015 to 19 percent in 2030), spending on Social Security, Medicare, and Medicaid will claim an even larger share of total outlays, assuming that health care costs keep growing faster than the economy. Over the long term, the increasing resource demands of such programs will exert pressure on the budget that will make current fiscal policy unsustainable.[5]

## A Review of 2004

The budget deficit continued to increase in 2004—growing to $412 billion from the $378 billion recorded for 2003. In relation to the size of the economy, the deficit was slightly bigger last year than in the previous year—3.6 percent of GDP versus 3.5 percent—but was smaller than the deficits of the mid-1980s and early 1990s (see Figure 1-1 on page 1).

Spending rose by more than 6 percent (or $132 billion) in 2004, totaling almost $2.3 trillion. Mandatory outlays grew by 5 percent ($56 billion), with Medicaid spending rising by almost 10 percent and Medicare outlays growing by more than 8 percent. Discretionary spending increased by 8 percent ($70 billion), led by outlays for defense, which rose by more than 12 percent ($49 billion). Roughly half of that increase resulted from spending for military operations in Iraq and Afghanistan and for other activities considered part of the war on terrorism (see Box 1-1 for details about the funding provided for those operations thus far). Discretionary outlays not related to defense grew only half as fast in 2004 as they did in 2003: by less than 5 percent (almost $20 billion). That growth was spread among numerous programs, with the largest increases occurring in the areas of international affairs ($6 billion), education ($4 billion), and health ($3 billion). (Recent federal spending and projections through 2015 are discussed in detail in Chapter 3.)

After declining for three years, revenues increased in 2004 by 5.5 percent (or $98 billion). Taxes on corporate income accounted for roughly 60 percent of that growth; receipts from those taxes were almost 44 percent higher last year than in 2003. Receipts from social insurance taxes rose by about 2.9 percent, and receipts from taxes on individual income grew by almost 2 percent. Taken as a whole, other sources of revenue grew by about 3 percent. (Chapter 4 provides more information about recent and projected federal revenues.)

## The Concept Behind CBO's Baseline Projections

The projections that make up CBO's baseline are not intended to be predictions of future budgetary outcomes—rather, they represent CBO's best judgment of how the economy and other factors would affect federal revenues and spending if current laws and policies remained the same. CBO constructs its baseline according to rules set forth in law, mainly in the Balanced Budget and Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974. In general, those laws spell out how CBO should project federal spending and revenues under current policies. The resulting baseline can be used as a neutral benchmark against which to measure the effects of proposed changes in tax and spending policies.

4. That calculation does not assume extension of the higher exemption amounts for the alternative minimum tax that were established by JGTRRA through 2004 and extended by WFTRA through December 2005. Also, that calculation does not incorporate any impact on the overall economy.

5. For an detailed discussion of the long-term pressures facing the federal budget, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003) and *The Outlook for Social Security* (June 2004).

**Box 1-1.**

## Appropriations for the Global War on Terrorism

Since September 2001, the Congress has provided about $197 billion in supplemental appropriations for military operations in Iraq and Afghanistan and for other activities in support of the global war on terrorism (see the table at right). Determining exactly how much of that budget authority has been spent is impossible because reports by the Department of the Treasury do not distinguish between outlays from regular appropriations and those from supplemental appropriations, nor do they distinguish between spending for peacetime operations and spending associated with the war on terrorism. Information from the Department of Defense (DoD) indicates that the department has obligated almost all of the $171 billion appropriated before August 2004 for operations in Iraq and Afghanistan and for other activities in the war on terrorism. Additionally, DoD reported that through September 2004, it had obligated $1.9 billion of the $26.8 billion appropriated in August as part of Public Law 108-287.

In fiscal year 2004, DoD obligated a total of $71.3 billion—or almost $6 billion per month—for Operations Iraqi Freedom, Enduring Freedom (in Afghanistan), and Noble Eagle (antiterrorism activities in the United States). Of that total, 80 percent was dedicated to Operation Iraqi Freedom, 14 percent to Operation Enduring Freedom, and 6 percent to Operation Noble Eagle. In all, half of the amount obligated in 2004 covered operation and support costs, such as for training, fuel, supplies, repair parts, maintenance of facilities, communications, and other contract services. Personnel costs accounted for another 31 percent of the total, 9 percent went for transporting troops and supplies, and the remaining 10 percent paid for new equipment and for construction projects.

For revenues and mandatory spending, the Deficit Control Act requires that the baseline be projected under the assumption that present laws continue without change.[6] In most cases, the laws that govern revenues and mandatory spending are permanent. Thus, the baseline projections reflect anticipated changes in the economy, demographics, and other relevant factors that affect the implementation of those laws.

The baseline rules differ for discretionary spending. The Deficit Control Act states that such spending should be projected by assuming that the most recent year's discretionary budget authority is provided in each future year, with adjustments to reflect projected inflation—using specified indexes—and other factors (such as the cost of annualizing adjustments to federal pay). If the current year's discretionary budget authority includes funds provided through supplemental appropriations, those funds are also adjusted for inflation and assumed to continue throughout the baseline period. As explained above, that rule—coupled with the timing of supplemental appropriations for operations in Iraq and Afghanistan—is a major source of the differences between CBO's current and previous baseline projections.

## Uncertainty and Budget Projections

Actual budgetary outcomes are almost certain to differ from CBO's baseline projections, both because of future legislative actions and because of unanticipated changes in economic conditions and in other factors that affect federal programs and revenue sources.

### The Budgetary Effects of Some Alternative Policies

To illustrate the potential effects of different fiscal policies on the baseline, CBO has estimated the budgetary impact of some alternative scenarios (see Table 1-3). The discussion below focuses on those scenarios' direct effects on revenues and outlays. However, their full impact would

6. Some exceptions exist under the Deficit Control Act. For example, spending programs that are set to expire must be assumed to continue if they have outlays of more than $50 million in the current year and were established on or before the enactment of the Balanced Budget Act of 1997. (Programs established after that are not automatically assumed to continue.) Similarly, expiring excise taxes that are dedicated to trust funds are assumed to be extended at the current rates. (The Deficit Control Act does not provide for the extension of other expiring tax provisions, even if they have routinely been extended in the past.)

## Box 1-1.
## Continued

### Appropriations Provided for Military Operations in Support of the Global War on Terrorism

| Public Law | Title | Budget Authority (Billions of dollars) 2001 | 2002 | 2003 | 2004 | Total |
|---|---|---|---|---|---|---|
| 107-38 (Sept. 2001) | 2001 Emergency Supplemental Appropriations Act for Recovery from and Response to Terrorist Attacks on the United States | 13.6 | | | | |
| 107-117 (Jan. 2002) | Department of Defense and Emergency Supplemental Appropriations for Recovery from and Response to Terrorist Attacks on the United States Act, 2002 | | 3.4 | | | |
| 107-206 (Aug. 2002) | 2002 Supplemental Appropriations Act for Further Recovery from and Response to Terrorist Attacks on the United States | | 13.8 | | | |
| 107-248 (Oct. 2002) | Department of Defense Appropriations Act, 2003 | | | 6.4 [a] | | |
| 108-7 (Feb. 2003) | Consolidated Appropriations Resolution, 2003 | | | 10.0 | | |
| 108-11 (April 2003) | Emergency Wartime Supplemental Appropriations Act, 2003 | | | 62.2 | | |
| 108-87 (Sept. 2003) | Department of Defense Appropriations Act, 2004 | | | | -3.5 [b] | |
| 108-106 (Nov. 2003) | Emergency Supplemental Appropriations Act for Defense and for the Reconstruction of Iraq and Afghanistan, 2004 | | | | 64.8 | |
| 108-287 (Aug. 2004) | Department of Defense Appropriations Act, 2005 | | | | 26.8 [c] | |
| | **Total** | **13.6** | **17.2** | **78.6** | **88.1** | **197.4** |

Source: Congressional Budget Office.

Note: The numbers in this table are amounts identified in appropriation acts as funding for Department of Defense activities in response to the terrorist attacks on September 11, 2001, and in support of the global war on terrorism, including military operations in Afghanistan and Iraq. They do not include funds for reconstruction activities in Iraq. (P.L. 108-11 provided $2.5 billion for that purpose, and P.L. 108-106 provided another $18.4 billion.) The amounts shown here represent funding directed to the Department of Defense (subfunction 051 of the federal budget).

a. This figure is an estimate based on conference report language for P.L. 107-248.

b. Rescission of funds appropriated in P.L. 108-11.

c. Of this amount, $25 billion is funding requested by the President for 2005 that will largely be used to cover costs incurred in that year, and $1.8 billion is funding restored from the repeal of a previous rescission. The Congress appropriated the funds in 2004 and made them available upon enactment, so the appropriation is counted as budget authority in 2004. As of September 2004, $1.9 billion of it had been obligated.

## Table 1-3.

# The Budgetary Effects of Selected Policy Alternatives Not Included in CBO's Baseline

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Policy Alternatives That Affect Discretionary Spending** | | | | | | | | | | | | | |
| Assume Phasedown of Activities in Iraq and Afghanistan and Continued Spending for the Global War on Terrorism[a] | | | | | | | | | | | | | |
| Effect on the deficit | -30 | -70 | -75 | -65 | -45 | -30 | -25 | -26 | -27 | -27 | -28 | -285 | -418 |
| Debt service | * | -3 | -7 | -11 | -14 | -17 | -19 | -22 | -24 | -27 | -29 | -51 | -172 |
| Increase Total Discretionary Appropriations at the Growth Rate of Nominal GDP | | | | | | | | | | | | | |
| Effect on the deficit | 0 | -15 | -40 | -68 | -97 | -126 | -156 | -186 | -217 | -249 | -283 | -347 | -1,437 |
| Debt service | 0 | * | -2 | -5 | -9 | -15 | -23 | -33 | -45 | -59 | -76 | -31 | -268 |
| Freeze Total Discretionary Appropriations at the Level Provided for 2005 | | | | | | | | | | | | | |
| Effect on the deficit | 0 | 14 | 32 | 52 | 74 | 97 | 121 | 144 | 169 | 195 | 221 | 269 | 1,118 |
| Debt service | 0 | * | 1 | 4 | 7 | 12 | 18 | 26 | 35 | 46 | 59 | 25 | 208 |
| **Policy Alternatives That Affect the Tax Code** | | | | | | | | | | | | | |
| Extend Expiring Tax Provisions[b] | | | | | | | | | | | | | |
| Effect on the deficit | | | | | | | | | | | | | |
| EGTRRA and JGTRRA | 0 | -3 | -4 | -11 | -23 | -19 | -160 | -259 | -269 | -281 | -292 | -60 | -1,321 |
| Other | * | -2 | -11 | -19 | -22 | -28 | -34 | -39 | -43 | -46 | -50 | -83 | -295 |
| Total | * | -5 | -16 | -30 | -45 | -47 | -194 | -298 | -312 | -327 | -342 | -143 | -1,616 |
| Debt service | * | * | -1 | -2 | -4 | -6 | -13 | -26 | -43 | -61 | -82 | -13 | -238 |
| Reform the Alternative Minimum Tax[c] | | | | | | | | | | | | | |
| Effect on the deficit | 0 | -12 | -34 | -41 | -50 | -60 | -50 | -27 | -33 | -40 | -47 | -198 | -395 |
| Debt service | 0 | * | -1 | -3 | -6 | -9 | -12 | -15 | -17 | -20 | -23 | -20 | -108 |
| **Memorandum:** | | | | | | | | | | | | | |
| Total Deficit (-) or Surplus in CBO's Baseline | -368 | -295 | -261 | -235 | -207 | -189 | -80 | 71 | 85 | 115 | 141 | -1,188 | -855 |

Sources: Congressional Budget Office; Joint Committee on Taxation.

Notes: EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003; * = between -$500 million and $500 million.

Positive amounts indicate a reduction in the deficit or an increase in the surplus. "Debt service" refers to changes in interest payments on federal debt resulting from changes in the government's borrowing needs.

a. This alternative assumes an eventual slowdown of U.S. activities in Iraq and Afghanistan but continued spending for the global war on terrorism throughout the 10-year period. It also includes funding for domestic military operations for homeland security.

b. This estimate does not include the effects of extending the increased exemption amount for the alternative minimum tax, which expires in December 2005. The effects of that alternative are shown below.

c. This alternative assumes that the exemption amount for the AMT (which was increased through December 2005 in the Working Families Tax Relief Act of 2004) is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2005. The estimates are shown relative to current law. If this alternative was enacted jointly with the extension of expiring tax provisions, an interactive effect would occur that would make the combined revenue loss greater than the sum of the two separate estimates by about $247 billion (plus $24 billion in debt-service costs) over the 2006-2015 period.

include their effect on federal debt-service costs, which is shown separately in the table.

Since military activities in Iraq and Afghanistan and other operations related to the global war on terrorism will continue in 2005 and for some unknown period thereafter, CBO has constructed a possible path of spending for such activities. It assumes that force levels and operations will remain at about the same levels in 2005 and 2006 as they did in 2004 and then will decline gradually over several years. Such a scenario might involve keeping about 200,000 active-duty, Reserve, and National Guard personnel deployed overseas to support those activities through fiscal year 2006. But over the longer term, it could involve reducing U.S. military involvement in those activities to about four brigades (40,000 troops) and decreasing domestic military operations for homeland security. Such a scenario would add about $30 billion to baseline discretionary outlays for 2005 and $418 billion for the 2006-2015 period.[7] Many other outcomes —some costing more and some costing less—are also possible for such activities.

In addition, alternative assumptions could be made about discretionary spending as a whole. For example, if current appropriations were assumed to grow at the same rate as nominal GDP through 2015 instead of at the rate of inflation, total projected discretionary spending would be $1.4 trillion higher. In the other direction, if lawmakers did not increase appropriations after 2005 to account for inflation, cumulative discretionary outlays would be $1.1 trillion lower.

Three mandatory programs—Social Security, Medicare, and Medicaid—dominate federal spending. In 2004, outlays for those programs totaled $965 billion (excluding offsetting receipts from Medicare premiums) and accounted for 42 percent of federal spending. Legislation could affect such large programs in significant ways. For example, the Administration is considering broad changes to the Social Security program, including allowing workers to divert part of their tax payments into private investments. No details are yet available, but such a plan could affect budgetary totals during the baseline period and well beyond. Likewise, changes in the laws that set payment rates, eligibility, and other criteria for Medicare and Medicaid are proposed and considered every year. For example, for each year since 2003, Medicare's payment rates for physicians' services (which are set by a procedure known as the sustainable growth rate formula) have been raised above the levels previously set by law. Further actions of that kind would lift outlays for Medicare considerably above baseline levels over the coming 10 years.

For revenues, CBO's baseline projections rest on the assumption that current tax laws do not change. For example, the baseline envisions that major provisions of EGTRRA—such as the introduction of the 10 percent tax bracket, increases in the child tax credit, and the repeal of the estate tax—will expire as scheduled at the end of 2010. On balance, the tax provisions that are set to expire during the projection period reduce revenues; thus, if they were assumed to be extended, projected revenues would be lower than the level in the baseline.[8] For example, if all expiring tax provisions (except those related to the exemption amount for the alternative minimum tax, or AMT) were extended, total revenues over the 2006-2015 period would be $1.6 trillion lower.[9]

Another policy change that could affect revenues involves modifying the AMT, which many observers believe cannot be maintained in its current form. The AMT's exemption amount and brackets are not indexed for inflation, which means that the impact of the tax will grow in coming years as more taxpayers become subject to it. If the AMT was indexed for inflation after 2005, federal revenues would be $395 billion lower over the next 10 years, according to CBO and the Joint Committee on Taxation.

### Other Sources of Uncertainty

Aside from the impact of future legislative actions, the federal budget is also sensitive to economic and technical factors that are difficult to forecast. In creating its baseline, CBO must make assumptions about such economic factors as interest rates, inflation, and the growth of GDP.

7. The scenario assumes that the military services would need to replace equipment that was destroyed, damaged, or worn out in those operations.

8. In the years before 2011, the largest contributors to the cost of extending those provisions are the research and experimentation tax credit and the reduced tax rates on dividends and capital gains.

9. Unlike CBO's baseline projections, which incorporate the effects that the expiration of tax provisions would have on the economy, that estimate does not include any macroeconomic effects. Such effects are likely to be small relative to the overall economy.

(CBO's economic assumptions are explained in detail in Chapter 2.) Discrepancies between those assumptions and actual economic conditions can have a significant impact on the extent to which budgetary outcomes differ from baseline projections. For instance, the baseline reflects an assumption that the real (inflation-adjusted) growth rate of GDP will slowly fall from 3.8 percent in calendar year 2005 to 2.5 percent in 2015. If the actual growth rate of GDP was 0.1 percent higher or lower per year, the cumulative deficit for the 2006-2015 period would differ from CBO's projections by about $260 billion. (For a further discussion of the effect of economic assumptions on budget projections, see Appendix A.)

Uncertainty also exists about technical factors—those not directly related to changes in law or in CBO's economic forecast—that affect budget projections. For example, spending per enrollee for both Medicare and Medicaid has been growing faster than per capita GDP. The future level of such "excess cost growth" is difficult to forecast, but it will have a large impact on the costs of those programs. In addition, projections of those costs depend on assumptions about the growth of enrollment in the programs and, indirectly, about general inflation. Similarly, CBO must estimate prices for various agricultural commodities as well as crop yields, all of which are volatile and significantly affect how much the government will pay farmers under price- and income-support programs.

Revenue projections too are vulnerable to technical uncertainty. Although the overall level of income is determined by economic projections, CBO must make technical assumptions about how much revenue to expect from a given amount of income. Differences between expected and actual revenue yields can lead to significant deviations from CBO's baseline projections.

Using the difference between past CBO baselines and actual budgetary results as a guide, Figure 1-3 displays a range of possible outcomes for the total deficit or surplus under current law (excluding the possible impact of future legislation). The current baseline projection of the deficit falls in the middle of the highest-probability area, shown as the darkest part of the figure. But nearby projections—other paths in the darkest part of the figure—have nearly the same probability of occurring that the baseline projection does. Projections that are increasingly different from the baseline are shown in lighter areas, but they also have a significant probability of coming to pass. For example, CBO projects a baseline deficit of 1.2 percent of GDP for 2010. However, under current law, there is roughly a 5 percent chance that the actual outcome that year will be a deficit greater than 6 percent of GDP. Similarly, in the absence of further legislative changes, there is a 35 percent chance that the budget will be in balance or surplus in 2010.

## The Long-Term Outlook

In the decades beyond CBO's projection period, the aging of the baby-boom generation, combined with rising health care costs, will cause a historic shift in the United States' fiscal situation. Over the next 30 years, the number of people age 65 or older will double, while the number of adults under age 65 will increase by less than 15 percent.[10] Moreover, health care costs are likely to continue to grow faster than the economy. (Between 1960 and 2001, the average annual growth rate of national health expenditures exceeded the growth rate of GDP by 2.5 percentage points.)

Driven by rising health care costs, spending for Medicare and Medicaid is increasing faster than can be explained by the growth of enrollment and general inflation alone. If excess cost growth continued to average 2.5 percentage points in the future, federal spending for Medicare and Medicaid would rise from 4.2 percent of GDP today to about 11.5 percent of GDP in 2030 (see Figure 1-4). The Medicare trustees assume that excess cost growth will decline to 1 percentage point, on average; however, even at that rate, federal spending for Medicare and Medicaid would double to 8.4 percent of GDP by 2030.[11]

Outlays for Social Security as a share of GDP are projected to grow by more than 40 percent in the next three decades under current law: from about 4.2 percent of GDP to more than 6 percent. Such costs are likely to creep up gradually thereafter. By contrast, federal revenues credited to Social Security are expected to remain close to their current level—around 5 percent of GDP—over that period.

Together, the growing resource demands of Social Security, Medicare, and Medicaid will exert pressure on the

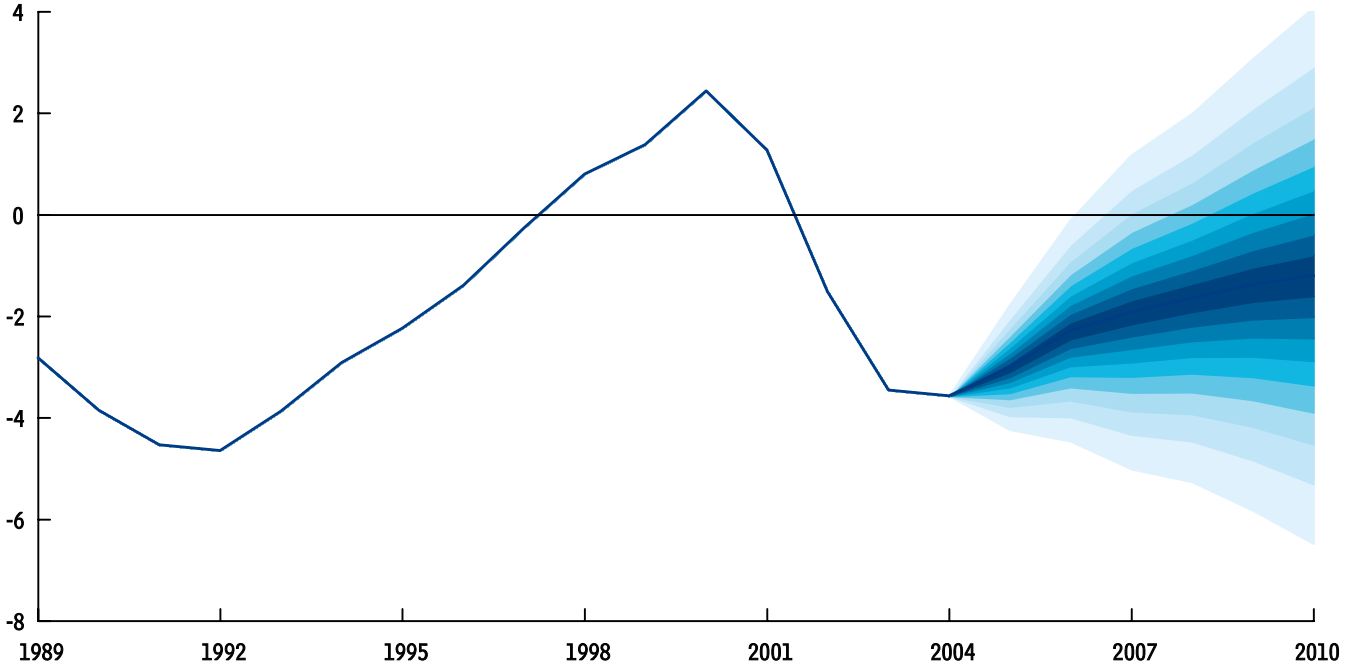
10. For a more extensive discussion, see CBO, *The Long-Term Budget Outlook* and *The Outlook for Social Security.*

11. See Technical Review Panel on the Medicare Trustees Reports, *Review of Assumptions and Methods of the Medicare Trustees' Financial Projections* (December 2000).

**Figure 1-3.**

## Uncertainty of CBO's Projections of the Budget Deficit or Surplus Under Current Policies

(Deficit or surplus as a percentage of GDP)




Source: Congressional Budget Office.

Notes: This figure, calculated on the basis of CBO's forecasting track record, shows the estimated likelihood of alternative projections of the budget deficit or surplus under current policies. The baseline projections described in this chapter fall in the middle of the darkest area of the figure. Under the assumption that tax and spending policies will not change, the probability is 10 percent that actual deficits or surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual deficits or surpluses will be affected by legislation enacted in future years, including decisions about discretionary spending. The effects of future legislation are not reflected in this figure.

For an explanation of how CBO typically calculates the probability distribution underlying figures such as this one, see Congressional Budget Office, *The Uncertainty of Budget Projections: A Discussion of Data and Methods* (April 2004).

budget that economic growth alone is unlikely to alleviate. Consequently, policymakers face choices that involve reducing the growth of federal spending, increasing taxation, boosting federal borrowing, or some combination of those approaches.

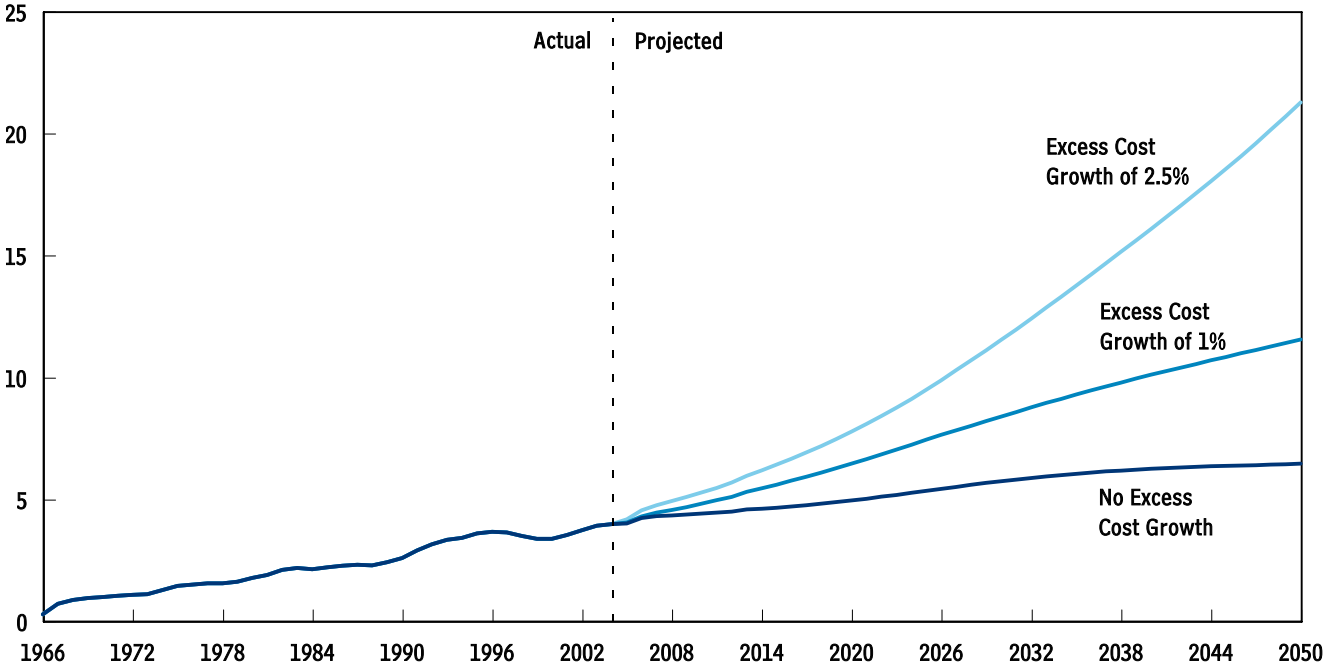
## Changes to the Budget Outlook Since September 2004

CBO's projection of the cumulative deficit for the 2005-2014 period has declined by $930 billion since last September, when the agency published its previous baseline. But that figure gives a misleading picture of changes to the underlying budget outlook. As illustrated in Table 1-1 on page 2, the apparent improvement in the projected 10-year deficit derives largely from the treatment of spending for operations in Iraq and Afghanistan. Because the statutes that govern the baseline require that all discretionary budget authority for the most recent year be extrapolated through the projection period, CBO's September baseline contained about $1.4 trillion in outlays (including debt-service costs) that are not in the current baseline, since no supplemental funding for Iraq and Afghanistan has yet been provided for 2005. Revisions to the baseline that are unrelated to the treatment of such funding partially offset that change, increasing projected deficits over the 2005-2014 period by more than $500 billion.

**Figure 1-4.**

## Total Federal Spending for Medicare and Medicaid Under Different Assumptions About Excess Cost Growth

(Percentage of GDP)




Source: Congressional Budget Office.

Note: "Excess cost growth" refers to the degree to which the annual growth rate of federal spending for Medicare and Medicaid exceeds the annual rate of gross domestic product.

When CBO revises its baseline projections, it divides the changes into three categories according to their cause: recently enacted legislation, changes to CBO's outlook for the economy, and technical factors that affect the budget.[12] Legislative changes have reduced the 10-year deficit by more than $1 trillion, primarily because of the treatment of supplemental funding for military operations. Changes to economic and technical assumptions have had a relatively small effect on the projections, combining to boost the cumulative deficit by $132 billion (less than 0.1 percent of GDP).

Outlay projections have declined by $17 billion for this year and by a total of $1.1 trillion (including debt-service costs) for the 2005-2014 period (see Table 1-4 on page 14). Removal from the baseline of the extrapolated $115 billion in supplemental appropriations enacted in 2004, which CBO categorizes as a legislative change, accounts for most of that decline. Changes in CBO's economic assumptions (particularly about inflation) and various technical changes have had a minor offsetting effect on projected outlays, increasing them by a total of $52 billion over 10 years.

CBO's revenue projections have declined by $37 billion for 2005 and by $209 billion for the 2005-2014 period. Together, laws enacted since September and technical changes have reduced projected revenues over the 10-year period by $281 billion, whereas revisions to economic

12. The categorization of revisions should be interpreted with caution. For example, legislative changes represent CBO's best estimates of the future effects of laws enacted since the previous baseline. If a new law proves to have different effects from the ones in CBO's initial estimate, the differences will appear as technical reestimates in later revisions to the baseline. The distinction between economic and technical revisions is similarly imprecise. CBO classifies economic changes as those resulting directly from changes in the components of CBO's economic forecast (interest rates, inflation, GDP growth, and so on). Changes in other factors related to the performance of the economy (such as the amount of capital gains realizations) are shown as technical reestimates.

assumptions have increased projected revenues by $72 billion.

### The Effects of Recent Legislation

Legislative changes to CBO's baseline since last September have increased this year's projected deficit by $6 billion but lowered the cumulative deficit through 2014 by more than $1 trillion. As noted above, most of that change results from differences in the treatment of spending for operations in Iraq and Afghanistan. In addition, laws enacted in the past five months have raised projected outlays by $242 billion and reduced projected revenues by $129 billion through 2014.

**Mandatory Spending.** Legislative changes since September have had little effect on the outlook for mandatory programs. Projected outlays for those programs have risen by $5 billion (excluding debt-service costs) for 2005, by $9 billion for 2006, and by a total of $12 billion for the 2005-2014 period.

One of the largest legislative changes to mandatory spending comes from the Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 (Public Law 108-375). That law prohibits the Air Force from leasing any tanker aircraft and repeals the authority that would have allowed the service to sign a contract to acquire 100 KC-767 tankers without regard to whether sufficient funds were available to pay the full costs of the contract. Because P.L. 108-375 prevents the Air Force from leasing or purchasing tankers without having an appropriation for the full cost of those aircraft, CBO estimates that the law will reduce mandatory spending for KC-767s by $18.5 billion over the 2005-2014 period relative to CBO's September baseline.

P.L. 108-375 also includes provisions that affect outlays for military retirement. On net, CBO estimates that those provisions will increase mandatory spending for military retirement over the 2005-2014 period by about $8 billion. Most of that increase comes from revisions to the survivor benefit plan (SBP) that phase out, over three-and-a-half years, the reduction in the SBP annuity that occurs when survivors become eligible for Social Security survivor benefits at age 62. The law also eliminates the 10-year phase-in for concurrent receipt of military retirement and veterans' disability compensation for retirees who are rated by the Department of Veterans Affairs as 100 percent disabled—a change that is projected to increase spending by nearly $1 billion through 2014.

The Military Construction Appropriations and Emergency Hurricane Supplemental Appropriations Act, 2005 (P.L. 108-324) is projected to add $2.6 billion to mandatory spending this year. That law provides emergency assistance to farmers who lost crops or livestock because of damaging weather.

The tobacco buyout provisions in the American Jobs Creation Act of 2004 (P.L. 108-357) will add an estimated $1.5 billion to spending in 2005 and roughly $1 billion each year from 2006 through 2014. That law also extends customs user fees through September 30, 2014—creating more than $20 billion in additional offsetting receipts (negative spending) over the 2005-2014 period.

The Working Families Tax Relief Act of 2004 (P.L. 108-311) contains several provisions that affect refundable tax credits. Most important, WFTRA raises the child tax credit to $1,000 through 2009. (It also increased the refundability of the credit in 2004.) Such changes are projected to add about $2 billion to outlays this year and nearly $24 billion over the 2005-2014 period.

The Commercial Spectrum Enhancement Act (P.L. 108-494) affects the timing of certain Federal Communications Commission (FCC) auctions of licenses to use the electromagnetic spectrum. It also creates new direct spending authority for agencies that currently use the frequencies due to be auctioned. The law sets an 18-month waiting period before the start of those auctions, which will delay the collection of $5 billion in receipts relative to CBO's previous baseline projections but will have no net effect on the budget over time. After purchasers pay for the licenses—which is now expected to occur in 2007 and 2008—the proceeds will be available to agencies without further appropriation to pay for any costs incurred to relocate federal services to other frequencies. CBO estimates that agencies will spend about $2.5 billion over the 2007-2014 period for those costs.

Finally, various smaller legislative changes to mandatory programs are projected to boost spending by about $5 billion over 10 years.

**Discretionary Spending.** Since September, CBO's baseline projections of discretionary spending have declined by $31 billion for 2005 and by more than $1 trillion for the 2005-2014 period because of revisions attributable to legislation.

**Table 1-4.**

## Changes in CBO's Baseline Projections of the Deficit Since September 2004

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Total, 2005-2009 | Total, 2005-2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Deficit as Projected in September 2004 | -348 | -298 | -308 | -318 | -312 | -298 | -200 | -70 | -75 | -65 | -1,584 | -2,294 |
| Changes to Revenue Projections | | | | | | | | | | | | |
| Legislative | -32 | -46 | -25 | -14 | -6 | -6 | * | 1 | * | -1 | -122 | -129 |
| Economic | -14 | -25 | -23 | -9 | 3 | 14 | 18 | 28 | 37 | 43 | -68 | 72 |
| Technical | 9 | 4 | -2 | -1 | -8 | -22 | -33 | -33 | -34 | -33 | 3 | -152 |
| **Total Revenue Changes** | **-37** | **-67** | **-49** | **-23** | **-11** | **-15** | **-15** | **-5** | **3** | **10** | **-187** | **-209** |
| Changes to Outlay Projections | | | | | | | | | | | | |
| Legislative | | | | | | | | | | | | |
| Discretionary | | | | | | | | | | | | |
| Defense | -33 | -76 | -89 | -93 | -95 | -97 | -100 | -101 | -104 | -106 | -386 | -895 |
| Nondefense | 1 | -6 | -12 | -14 | -15 | -15 | -15 | -15 | -14 | -14 | -46 | -119 |
| Subtotal, discretionary | -31 | -82 | -101 | -107 | -110 | -112 | -115 | -116 | -119 | -121 | -432 | -1,014 |
| Mandatory | 5 | 9 | 1 | 1 | 3 | 2 | -2 | -2 | -2 | -2 | 19 | 12 |
| Net interest (Debt service) | * | * | -3 | -7 | -13 | -19 | -25 | -33 | -40 | -49 | -23 | -189 |
| Subtotal, legislative | -26 | -74 | -103 | -114 | -119 | -130 | -142 | -151 | -161 | -171 | -436 | -1,191 |
| Economic | | | | | | | | | | | | |
| Discretionary | 0 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 1 | 8 | 18 |
| Mandatory | -1 | 4 | 5 | 2 | 9 | -1 | 1 | * | -1 | -11 | 20 | 8 |
| Net interest | | | | | | | | | | | | |
| Debt service | * | 1 | 3 | 4 | 4 | 4 | 4 | 3 | 2 | -1 | 12 | 24 |
| Rate effect/inflation | -1 | -4 | -4 | -3 | -2 | -2 | -1 | -1 | -1 | -1 | -14 | -18 |
| Subtotal, net interest | -1 | -3 | -1 | 1 | 2 | 3 | 3 | 2 | 1 | -1 | -2 | 5 |
| Subtotal, economic | -3 | 3 | 6 | 6 | 13 | 4 | 6 | 4 | 2 | -11 | 26 | 31 |

**Continued**

As noted above, no supplemental funding for activities in Iraq and Afghanistan has yet been provided in 2005 (the current base year used to project discretionary spending), although about $115 billion was provided in 2004 (the base year for the September projections). Because of that difference, CBO has had to decrease its projections of discretionary spending relative to the September baseline by $38 billion for 2005 and by more than $1.1 trillion (not including associated debt-service costs) through 2014.

Increases in other appropriations have offset that decrease slightly. The 2005 Military Construction Appropriations and Emergency Hurricane Supplemental Appropriations Act provides $11.5 billion in supplemental appropriations for relief from natural disasters and other purposes. Extrapolating that budget authority through 2014 adds $94 billion in outlays to the baseline. Also, $2 billion in supplemental funding for disaster relief was provided in September (after CBO's baseline had been completed); those outlays are anticipated to occur during the 2005-2008 period.

In addition, regular appropriations for 2005 for agencies other than the Department of Defense are slightly higher, overall, than the amounts assumed in the September baseline. Although funding has risen for most areas of the budget, the largest increases are in the general categories of transportation, federal law enforcement, and veterans'

**Table 1-4.**

## Continued

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Total, 2005-2009 | Total, 2005-2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Changes to Outlay Projections (Cont'd) | | | | | | | | | | | | |
| Technical | | | | | | | | | | | | |
| Discretionary | -3 | -6 | -2 | * | -2 | -3 | -4 | -5 | -5 | -5 | -13 | -34 |
| Mandatory | | | | | | | | | | | | |
| Medicaid | 3 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 2 | 1 | 19 | 33 |
| Food Stamps | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 15 | 30 |
| Unemployment Insurance | -4 | -5 | -3 | -3 | -3 | -3 | -2 | -2 | -1 | * | -19 | -26 |
| Farm programs (CCC) | 8 | 6 | 3 | * | -1 | -1 | -1 | -2 | -2 | -1 | 15 | 8 |
| Credit reestimates | 7 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 7 | 7 |
| Other | -2 | -2 | -2 | * | -8 | 3 | * | -3 | -4 | 4 | -14 | -14 |
| Subtotal, mandatory | 14 | 7 | 5 | 4 | -6 | 6 | 3 | * | -1 | 7 | 25 | 39 |
| Net interest | | | | | | | | | | | | |
| Debt service | * | -1 | -1 | -1 | * | * | 2 | 3 | 5 | 7 | -2 | 16 |
| Other | 1 | -1 | -2 | -1 | -2 | -1 | * | 1 | 2 | 2 | -4 | 1 |
| Subtotal, net interest | 1 | -1 | -2 | -1 | -2 | -1 | 2 | 5 | 7 | 10 | -6 | 16 |
| Subtotal, technical | 11 | * | 1 | 2 | -10 | 2 | 1 | * | 1 | 11 | 5 | 21 |
| **Total Outlay Changes** | **-17** | **-70** | **-96** | **-106** | **-116** | **-124** | **-135** | **-146** | **-158** | **-171** | **-405** | **-1,139** |
| **Total Impact on the Deficit** | **-20** | **4** | **47** | **83** | **104** | **109** | **120** | **142** | **161** | **180** | **218** | **930** |
| Total Deficit (-) or Surplus as Projected in January 2005 | -368 | -295 | -261 | -235 | -207 | -189 | -80 | 71 | 85 | 115 | -1,366 | -1,364 |
| **Memorandum:** | | | | | | | | | | | | |
| Total Legislative Changes | -6 | 28 | 79 | 100 | 113 | 123 | 142 | 151 | 161 | 170 | 314 | 1,062 |
| Total Economic Changes | -11 | -28 | -29 | -15 | -10 | 10 | 12 | 24 | 35 | 54 | -94 | 41 |
| Total Technical Changes | -2 | 4 | -3 | -3 | 1 | -24 | -34 | -33 | -35 | -44 | -2 | -173 |

Source: Congressional Budget Office.

Note: * = between -$500 million and $500 million; CCC = Commodity Credit Corporation.

health care. Extrapolating all of the changes in 2005 regular appropriations through 2014 raises projected outlays by a total of $32 billion over the 10-year period.

**Revenues.** Legislative changes have reduced projected receipts by $129 billion over the 2005-2014 period, with virtually all of that reduction occurring before 2011. By far the most significant change—accounting for $122 billion of the reduction—results from the enactment of WFTRA, which extends a number of expiring provisions first enacted in the Economic Growth and Tax Relief Reconciliation Act and then modified in the Jobs and Growth Tax Relief Reconciliation Act. Under EGTRRA, the amounts of the increased child credit, the expanded 10 percent tax bracket, and marriage-penalty relief had been set to phase in over time; JGTRRA accelerated that timing so all of the amounts were fully phased in by 2004, but only for that year. WFTRA maintains those amounts at their fully phased-in levels through 2010, after which all of the provisions enacted in EGTRRA are due to expire. The decline in revenues from that change is concentrated in the next few years, before the higher amounts would have been fully phased in under prior law. Other changes in WFTRA also contribute to reducing revenues early in the projection period. The law extends through 2005 the higher exemption amount for the

alternative minimum tax as well as a number of tax provisions (such as the research and experimentation credit) that had regularly been extended temporarily over the years but had already expired.

In addition, the recently enacted American Jobs Creation Act makes numerous changes to tax law, such as replacing an exclusion of income earned by exporters with a deduction of income from domestic production. That law has reduced projected revenues by a total of $7 billion through 2014.

**Net Interest.** Together, revisions to the September baseline that are classified as legislative decrease the cumulative deficit for the 2005-2014 period by $873 billion (excluding debt service). In turn, that reduction in the need to borrow is projected to lessen the government's debt-service costs through 2014 by a total of $189 billion. As a result, legislative revisions reduce the projected cumulative deficit by more than $1 trillion in all.

### The Effects of Economic Changes

Updates to CBO's economic assumptions since September have had a relatively minor effect on the budget outlook. Such changes increase this year's projected deficit by $11 billion (almost entirely on the revenue side of the budget) but decrease the total deficit projected for the 2005-2014 period by $41 billion (through raising projected revenues by $72 billion and projected outlays by $31 billion). CBO is now forecasting slightly lower levels of nominal GDP and wages in the next few years, and slightly higher levels in later years, than it did last September (see Chapter 2), which reduces estimated revenues in the near term and raises them thereafter. In addition, CBO's new forecast envisions a higher rate of inflation this year and a slightly lower rate next year than the previous forecast did.

**Mandatory Spending.** Food Stamps, Medicaid, and Social Security are the three mandatory programs most affected by changes to the economic forecast. Those changes have increased projections of mandatory spending by $20 billion for 2005 through 2009 and lowered them by about $12 billion for the following five years—on net, adding $8 billion to projected mandatory outlays for the 2005-2014 period.

Since September, CBO has raised its near-term forecast of the consumer price index for the cost of food purchased for consumption at home. As a result, average Food Stamp benefits are projected to increase, boosting outlays for the program by $12 billion over 10 years.

In the Medicaid program, payment rates for services are generally not linked to specific price factors. Nevertheless, CBO anticipates that changes in its economic outlook will affect spending for the program. In particular, the decline in projected medical inflation will reduce Medicaid spending for hospital and physicians' services, CBO projects. To a lesser extent, lower projected wage growth will reduce spending for long-term care, which is influenced by labor costs. Because of those changes to the economic forecast, CBO currently estimates that federal Medicaid spending will be $8 billion lower over the next 10 years than previously projected.

The cost-of-living adjustment (COLA) that Social Security beneficiaries will receive in January 2006 is now expected to be 0.5 percentage points higher than CBO projected in September, increasing benefit payments in 2006 and beyond. Changes to projections of nominal wages also affect Social Security spending by changing projections of initial benefits for new recipients. In all, such economic revisions increase projected Social Security spending over the 2005-2014 period by $5 billion.

The COLA reestimate also produces a small increase in projected spending for other programs, including civil service retirement, military retirement, Supplemental Security Income, and some veterans' benefits.

**Discretionary Spending.** As explained above, most of the revisions to projections of discretionary spending result from legislative changes. But changes in CBO's assumptions about two measures of inflation—the GDP price deflator (which covers the changes in prices of all goods and services that contribute to GDP) and the employment cost index for wages and salaries—cause a small net increase ($18 billion) in projected discretionary spending through 2014.

**Revenues.** Changes in CBO's economic outlook have had a relatively minor effect on revenue projections, lowering them through 2008 and raising them thereafter—for a net increase of $72 billion over the 2005-2014 period. CBO has reduced its forecasts of the growth of GDP and personal income for this year and raised them for later years. By 2007, personal income is projected to exceed the amount projected in September. That pattern reduces projected receipts from individual income and payroll

taxes through 2006 and boosts them thereafter. CBO is also anticipating lower corporate profits throughout the projection period than it did last September, which reduces projected receipts from corporate income taxes, mostly in the near term.

**Net Interest.** Economic revisions to projected spending for net interest have two components: the effects of changes in projected interest rates and inflation and the effects of additional (or reduced) debt service. In the current economic forecast, interest rates on 10-year Treasury notes are about half a percentage point lower in 2005 and marginally lower in 2006 than previously anticipated. However, savings from those lower long-term rates are partially offset by increased outlays resulting from higher projections of short-term rates in those two years. Overall, such changes in CBO's economic forecast reduce projected outlays for net interest by $18 billion over 10 years.

In addition, changes in the economic outlook increase projected deficits between 2005 and 2009, adding a total of $12 billion to debt-service costs during those years. The growth of such costs reverses later in the projection period: economic revisions lower projected deficits, causing additional debt-service charges to decline each year (from a cost of $4 billion in 2010 to a savings of less than $1 billion in 2014).

### The Effects of Technical Changes

Technical changes represent all other revisions to the baseline not directly related to recent laws or to changes in the components of CBO's economic forecast. Over the 2005-2014 period, technical revisions increase the cumulative deficit by $173 billion, mainly by reducing projected revenues.

**Mandatory Spending.** Because of technical adjustments, CBO is projecting an additional $14 billion in mandatory spending this year and $39 billion (or 0.2 percent) over the 2005-2014 period relative to the previous baseline. Most of the increase results from higher projected spending for the Medicaid and Food Stamp programs, partly offset by reductions in projected unemployment insurance payments.

A variety of technical revisions have added $33 billion (or 1.3 percent) to CBO's projection of federal spending for Medicaid over 10 years. Those revisions reflect the fact that Medicaid spending in 2004 was higher than anticipated and that the number of people expected to enroll in the program has increased. The impact of those changes on spending is largely offset by lower estimates of growth in per capita spending.

Projected outlays for the Food Stamp program over the 2005-2014 period have grown by $30 billion since the September baseline because CBO's estimate of participation in the program has increased. Rates of participation have persistently been higher than expected for the past few years, despite falling unemployment rates. The magnitude of the increase has led CBO to conclude that there is a slightly longer lag between declines in the unemployment rate and declines in Food Stamp participation than previously believed. In addition, legislative changes to the program in recent years have led to an increase in outreach efforts, an expansion of eligibility, and some simplification of the application process. For all of those reasons, more people appear to be applying for benefits than was the case in the past.

Outlays for unemployment compensation over the 10-year projection period are $26 billion lower in the current baseline than in the previous baseline. More than half of that change comes from a reduction in the number of people expected to claim benefits (based on recent and historical rates of insured unemployment). About 8.7 million people received unemployment compensation in 2004; CBO expects that number to decline to about 8.4 million this year. In addition, about 40 percent of the change in estimated outlays is attributable to lower projected average benefits. States are responsible for setting the parameters under which people can claim benefits, with maximum amounts generally tied to some measure of average wages. The average benefit in 2004 grew little from the previous year, thus creating a lower base for projecting benefits for coming years.

Prices of some major agricultural commodities—especially feed grains, cotton, and soybeans—have experienced sharp declines. That and other factors have led CBO to raise its estimates of spending by the Commodity Credit Corporation (CCC) for farm price-support and income-support payments in 2005 through 2007 by a total of $17 billion. Projections of CCC spending in later years have declined slightly, for a net increase of $8 billion over the 2005-2014 period.

CBO's projection of mandatory spending in 2005 reflects another technical change: a net increase in the estimated subsidy cost for a number of federal programs that make

loans directly to individuals or businesses or that guarantee loans made by private financial institutions. The budget records the cost of such credit programs as the projected net present value of government losses on outstanding loans and guarantees. Accurately projecting loan repayments, defaults, and changes in interest rates over the life of a credit program is difficult, however. As a result, federal agencies annually revise their estimates of costs for loans and guarantees made in previous years. On the basis of preliminary information from the Administration, CBO has raised its estimate of mandatory outlays in 2005 by $7 billion to reflect such revisions. The reestimates affect a variety of programs, including the Federal Housing Administration's Mutual Mortgage Insurance program, the FCC's spectrum auctions, the Small Business Administration's business loan programs, and federal student loan programs.

**Discretionary Spending.** Technical revisions to the baseline have reduced projections of discretionary outlays by $3 billion for 2005 and by a total of $34 billion (or 0.3 percent) for the 2005-2014 period. Those revisions affect nearly all areas of the budget, but the largest change involves the program that provides housing vouchers for low-income renters. CBO has adopted a new estimating method that will better align the baseline for that program with the intent of the Deficit Control Act and will treat the program's accounts in the same way as other discretionary accounts. The Deficit Control Act's procedure for producing a baseline for that program reflects the fact that when the law was enacted, the voucher program featured many multiyear contracts, which received all of their funding at the beginning of the contract period. That is no longer the case; today, most contracts are for only one year. As a result, CBO now projects budget authority for the voucher program the same way that it does for most other discretionary programs (by inflating the current year's budget authority) and then includes an add-on for expiring multiyear contracts. That new approach reduces projected outlays for the program by $24 billion over 10 years.

**Revenues.** CBO has lowered its revenue projections for the 2005-2014 period by $152 billion as a result of technical changes. Most of those changes apply to receipts from individual income taxes and occur in the second half of the projection period (totaling $155 billion between 2010 and 2014). Technical changes are quite small for 2005 through 2009.

The main changes in the later years of the projection derive from two sources: information that is now available from 2002 tax returns, and new estimates of the effects of asset accumulations in tax-deferred retirement accounts, such as individual retirement accounts and 401(k) accounts. Tax returns for 2002 show lower amounts of taxable income than CBO anticipated, and CBO expects that the causes of that shortfall will continue through the later years of the projection period, thereby reducing receipts. In addition, new estimates of activity in retirement accounts indicate that accrual of dividend and interest income in taxable accounts is likely to be smaller than CBO projected earlier. Those two factors also reduce revenues in the first five years of the projection, but the reduction is largely offset by a change in CBO's estimate of the effects of a cut in the tax rates on dividends (which will expire in 2009). CBO now believes that the cut will not lower revenues as much as previously thought.

**Net Interest.** New information about the composition and amount of federal debt and additional details about federal interest payments and receipts have led CBO to increase its projections of net interest outlays by $1 billion (excluding debt service) over the 2005-2014 period. In addition, because technical changes to the baseline increase the cumulative deficit over that period by $157 billion, federal debt-service costs are projected to rise by a total of $16 billion.

## The Outlook for Federal Debt

The federal government's debt falls into two main categories: debt that is held by the public (in the form of marketable and nonmarketable Treasury securities) and debt that is held by government accounts. Debt held by the public is the more meaningful measure in terms of the relationship between federal debt and the economy. It represents debt that the Department of the Treasury issues to raise cash to fund the operations and pay off the maturing liabilities of the federal government. Debt held by government accounts consists of securities that the Treasury issues to various federal agencies. Those intragovernmental IOUs are used as an accounting device to track cash flows relating to specific federal programs, such as Social Security.

### Debt Held by the Public

When the federal government runs a deficit, the Treasury borrows money from the public by selling securities in the capital markets to various buyers, such as foreign in-

vestors, mutual funds, state and local governments, commercial banks, insurance companies, and individuals. Of those groups, foreign investors (governments, businesses, and individuals) are currently the largest owners of federal debt issued to the public. They hold nearly $1.9 trillion—or more than 43 percent—of the roughly $4.3 trillion that is now outstanding.

Among foreign countries, investors in Japan, China, and the United Kingdom have the largest holdings of Treasury securities.[13] The central bank and private entities in Japan alone hold about $715 billion in such securities, more than $229 billion of which were bought in 2004—equal to roughly 55 percent of the U.S. deficit that year. In all, foreign investors purchased nearly $399 billion in Treasury securities last year—just $13 billion less than the size of the 2004 deficit.

State and local governments and mutual funds in the United States are also large investors in Treasury securities. Those governments hold $368 billion in debt held by the public, and mutual funds hold $258 billion.[14]

Debt held by the public fluctuates according to changes in the government's borrowing needs. It equaled nearly 50 percent of GDP in 1993 but fell to about 33 percent of GDP by 2001 (see Figure 1-2 on page 4). Over the past three years, debt held by the public has crept up to 37 percent of GDP. Under the baseline assumption that current law does not change (for example, that no further funding is provided for operations in Iraq and Afghanistan and that taxes rise as scheduled), debt held by the public is projected to peak at 39 percent of GDP in 2007 and then fall steadily to 29 percent of GDP in 2015 (see Table 1-5).

**The Composition of Debt Held by the Public.** Roughly 90 percent of publicly held debt consists of marketable securities—Treasury bills, notes, bonds, and inflation-indexed issues (called TIPS). The remaining 10 percent comprises nonmarketable securities, such as savings bonds and state and local government securities, which are nonnegotiable, nontransferable debt instruments issued to specific investors.[15]

The Treasury sells marketable securities to brokers in regularly scheduled auctions, whose size varies along with changes in the government's cash flow. (The Treasury also sells cash-management bills periodically to cover shortfalls in cash balances.) In 2004, the Treasury changed its mix of marketable securities to meet investors' growing demand for assets that protect against inflationary risks: it introduced a 20-year TIPS bond, which is issued on a semiannual basis, and began issuing five-year TIPS notes semiannually in October. Those changes could attract new investors, and the addition of a TIPS security with a longer maturity will diversify the Treasury's portfolio. However, those changes could increase the Treasury's exposure to inflationary risks.

**Why Changes in Debt Held by the Public Do Not Equal the Size of Deficits and Surpluses.** In most years, the amount of debt that the Treasury borrows or redeems approximates the annual budget deficit or surplus. However, a number of factors—which are broadly labeled "other means of financing"—also affect the government's need to borrow money from the public. CBO projects that debt held by the public will increase by more than the cumulative deficit over the 2005-2015 period because changes in other means of financing will raise the Treasury's borrowing needs (see Table 1-5).

In most years, the largest of the other means of financing is the capitalization of financing accounts used for federal credit programs. Direct student loans, rural housing programs, loans by the Small Business Administration, and other credit programs require the government to disburse money up front in anticipation of repayment at a later date. Those initial outlays are not counted in the budget, which reflects only the estimated subsidy costs of such programs. From 2006 through 2015, the amount of loans being disbursed will typically be larger than the amount of repayments and interest being collected. Thus, the government's annual borrowing needs will be $11 billion to $15 billion greater than the annual budget deficit or surplus would indicate.

13. See Department of the Treasury, "Major Foreign Holders of Treasury Securities" (December 15, 2004), available at www.ustreas.gov/tic/mfh.txt. That information should be viewed as approximate because the Treasury's data indicate the country where a purchase was made, which is not necessarily the purchaser's home country.

14. Department of the Treasury, Financial Management Service, *Treasury Bulletin* (December 2004).

15. State and local government securities are time deposits that the Treasury sells to the issuers of state and local government tax-exempt debt to assist in the restriction of arbitrage provisions in the Internal Revenue Code.

**Table 1-5.**

## CBO's Baseline Projections of Federal Debt

(Billions of dollars)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Debt Held by the Public at the Beginning of the Year | 3,913 | 4,296 | 4,665 | 4,971 | 5,246 | 5,494 | 5,716 | 5,919 | 6,012 | 5,955 | 5,884 | 5,784 |
| Changes to Debt Held by the Public | | | | | | | | | | | | |
| Deficit or surplus (-) | 412 | 368 | 295 | 261 | 235 | 207 | 189 | 80 | -71 | -85 | -115 | -141 |
| Other means of financing | -30 | 2 | 11 | 14 | 13 | 14 | 14 | 13 | 14 | 14 | 15 | 16 |
| Total | 382 | 370 | 306 | 275 | 249 | 222 | 203 | 93 | -58 | -71 | -100 | -126 |
| Debt Held by the Public at the End of the Year | 4,296 | 4,665 | 4,971 | 5,246 | 5,494 | 5,716 | 5,919 | 6,012 | 5,955 | 5,884 | 5,784 | 5,658 |
| Debt Held by Government Accounts | | | | | | | | | | | | |
| Social Security | 1,635 | 1,804 | 1,989 | 2,194 | 2,419 | 2,661 | 2,919 | 3,191 | 3,475 | 3,768 | 4,068 | 4,372 |
| Other government accounts[a] | 1,424 | 1,505 | 1,605 | 1,707 | 1,813 | 1,927 | 2,047 | 2,169 | 2,301 | 2,442 | 2,582 | 2,725 |
| Total | 3,059 | 3,310 | 3,594 | 3,901 | 4,232 | 4,588 | 4,965 | 5,361 | 5,776 | 6,210 | 6,650 | 7,097 |
| Gross Federal Debt | 7,355 | 7,975 | 8,565 | 9,146 | 9,726 | 10,304 | 10,884 | 11,373 | 11,731 | 12,094 | 12,434 | 12,755 |
| Debt Subject to Limit[b] | 7,333 | 7,939 | 8,529 | 9,111 | 9,690 | 10,268 | 10,847 | 11,336 | 11,693 | 12,056 | 12,395 | 12,716 |
| **Memorandum:** | | | | | | | | | | | | |
| Debt Held by the Public at the End of the Year as a Percentage of GDP | 37.2 | 38.1 | 38.6 | 38.6 | 38.4 | 38.0 | 37.6 | 36.5 | 34.5 | 32.6 | 30.7 | 28.8 |

Source: Congressional Budget Office.

a. Mainly the Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance Trust Funds.

b. Differs from gross federal debt primarily because it excludes most debt issued by agencies other than the Treasury. The current debt limit is $8,184 billion.

In 2004, the relationship between the change in accumulated debt and the size of the deficit went in the other direction—debt held by the public grew by $30 billion less than the size of the deficit. The elimination of a program that allowed the Treasury to withdraw certain nonmarketable securities (called depositary compensation securities) and interest-free loans (called compensating balances) from financial institutions that had provided services to the Treasury accounted for about $22 billion of that difference ($14 billion from depositary compensation securities and $8 billion from compensating balances). The program ended after the Treasury received an appropriation in the Consolidated Appropriations Act, 2004 (P.L. 108-199) to pay those financial institutions directly. In addition, the government's borrowing requirements were lowered by $5 billion in 2004 when the International Monetary Fund repaid a portion of the Treasury's reserve assets.

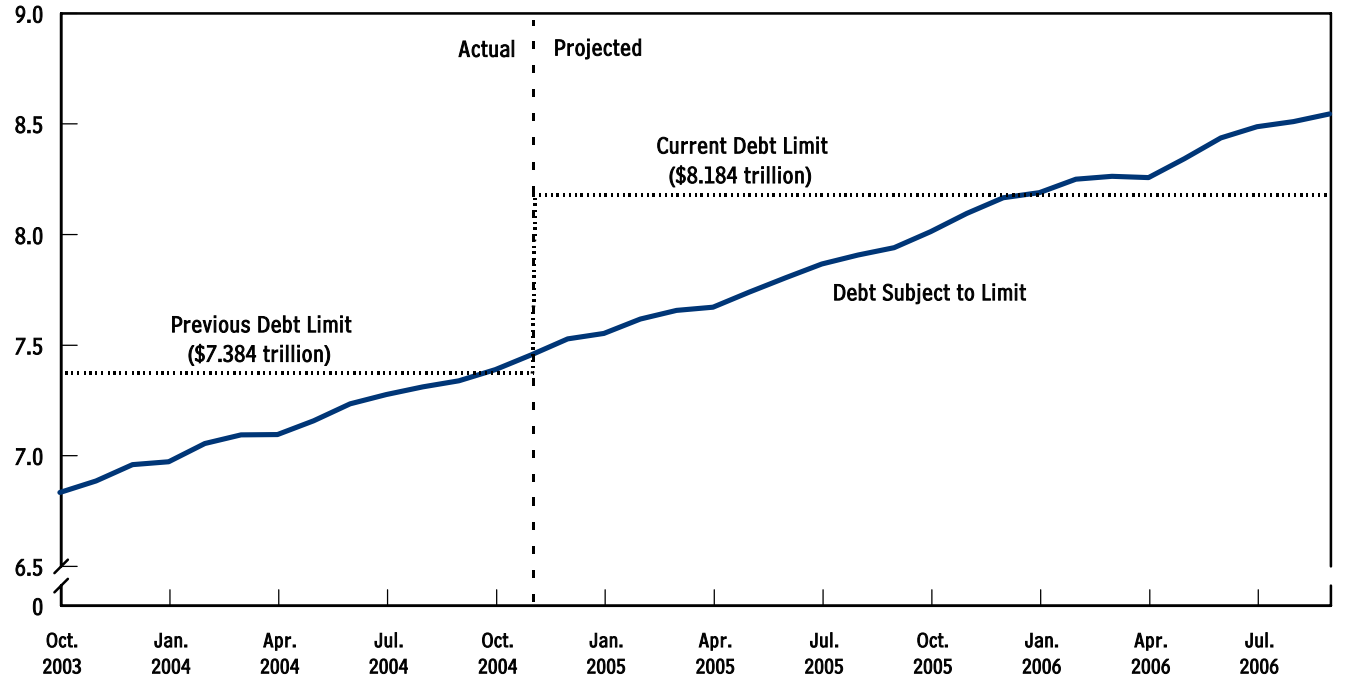
### Debt Held by Government Accounts

Besides selling securities to the public, the Treasury has issued about $3.1 trillion in securities to various accounts of the federal government (as of the end of fiscal year 2004). All of the major trust funds in the budget and many other government funds invest in special, nonmarketable Treasury securities known as the government account series. (Trust funds are described in more detail at the end of this chapter.) Those investments are intragovernmental transactions and have no direct effect on the economy. The securities represent credits to the various government accounts and are redeemed when necessary to cover benefit payments and other expenses. In the meantime, the Treasury assigns interest earnings to the

**Figure 1-5.**

## Debt Subject to Limit, October 2003 to September 2006

(Trillions of dollars)




Source: Congressional Budget Office.

funds that hold those securities; such payments have no net effect on the budget.

The largest balances of such debt are in the Social Security trust funds (more than $1.6 trillion at the end of 2004) and the retirement funds for federal civilian employees ($632 billion). If current policies do not change, the balance of the Social Security trust funds will rise to $4.4 trillion by 2015, CBO projects, and the balance of all government accounts will climb to $7.1 trillion (see Table 1-5).

### Gross Federal Debt and Debt Subject to Limit

Gross federal debt and its companion measure, debt subject to limit, comprise debt issued to government accounts as well as debt held by the public. The future path of gross federal debt is determined by the sum of those two components. CBO projects that under current law, gross federal debt will increase in every year of the projection period and reach almost $12.8 trillion in 2015—roughly 73 percent more than the 2004 total of nearly $7.4 trillion. Most of that increase reflects debt held by government accounts. Under current law, more than half of the gross federal debt in 2015 would be held by government accounts—that is, money owed by the government to itself.

The Treasury's authority to issue debt is restricted by a statutory ceiling. Although that limit covers debt held by the public and by government accounts, it does not include debt issued by agencies other than the Treasury (such as the $26 billion in debt issued by the Tennessee Valley Authority and the $14 billion issued by the Federal Financing Bank). The current debt ceiling, which was set in November 2004 in P.L. 108-415, is $8.184 trillion (see Figure 1-5). CBO estimates that under current policies, that ceiling will be reached between November 2005 and February 2006.

At that time, if a higher debt limit has not been enacted, the Treasury will have to use accounting measures to remain under the debt ceiling so it can continue to raise cash to pay for government activities. Those accounting measures—most of which have been used in the past—could include suspending the issuance of certain securities held in the Thrift Savings Plan, postponing the issu-

**Table 1-6.**

## CBO's Baseline Projections of Trust Fund Surpluses

(Billions of dollars)

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Social Security | 151 | 169 | 185 | 205 | 225 | 242 | 258 | 273 | 284 | 293 | 300 | 304 |
| Medicare | | | | | | | | | | | | |
| Hospital Insurance (Part A) | 13 | 13 | 16 | 22 | 24 | 27 | 29 | 30 | 27 | 33 | 28 | 25 |
| Supplementary Medical Insurance (Part B) | -8 | 3 | 3 | 1 | 2 | 4 | 5 | 2 | 9 | 6 | 4 | 5 |
| Subtotal, Medicare | 5 | 17 | 18 | 23 | 27 | 31 | 34 | 32 | 36 | 39 | 32 | 30 |
| Military Retirement | 10 | 11 | 10 | 10 | 10 | 10 | 11 | 12 | 13 | 14 | 14 | 15 |
| Civilian Retirement[a] | 30 | 32 | 31 | 31 | 32 | 32 | 32 | 32 | 32 | 33 | 33 | 34 |
| Unemployment | -3 | 11 | 12 | 9 | 6 | 4 | 3 | 3 | 4 | 4 | 4 | 5 |
| Highway and Mass Transit | -3 | -2 | -3 | -3 | -3 | -2 | -2 | -2 | -1 | -1 | -1 | * |
| Airport and Airways | * | 1 | 1 | 1 | 2 | 2 | 3 | 3 | 4 | 4 | 5 | 5 |
| Other[b] | -1 | 4 | 4 | 4 | 4 | 6 | 5 | 5 | 5 | 5 | 5 | 5 |
| **Total Trust Fund Surplus** | **189** | **242** | **259** | **280** | **302** | **325** | **343** | **358** | **376** | **391** | **393** | **398** |
| Intragovernmental Transfers to Trust Funds[c] | 380 | 406 | 449 | 496 | 532 | 571 | 615 | 662 | 713 | 767 | 824 | 885 |
| **Net Budgetary Impact of Trust Fund Programs** | **-192** | **-164** | **-190** | **-216** | **-230** | **-246** | **-272** | **-304** | **-337** | **-377** | **-431** | **-487** |

Source: Congressional Budget Office.

Note: * = between -$500 million and zero.

a. Includes the Civil Service Retirement, Foreign Service Retirement, and several smaller retirement trust funds.

b. Primarily trust funds for Railroad Retirement, federal employees' health and life insurance, Superfund, and various veterans' insurance programs.

c. Includes interest paid to trust funds, payments from the general fund to the Supplementary Medical Insurance program, employers' share of employee retirement, lump-sum payments to the Civil Service and Military Retirement Trust Funds, taxes on Social Security benefits, and smaller miscellaneous payments.

ance of state and local government series securities, delaying the issuance of securities to the Civil Service Retirement Trust Fund, or withdrawing federal securities from the Exchange Stabilization Fund. In recent years, when the Treasury has bumped into the debt ceiling, such accounting maneuvers have enabled it to remain below the debt limit for one to three months. (However, unlike in the past two instances, the Treasury will be unable next time to clear significant room under the debt ceiling by swapping securities with the Federal Financing Bank. The bank is limited to issuing $15 billion of its own debt; it has already issued $14 billion, which is currently held by the Civil Service Retirement and Disability Fund.)

## Trust Funds and the Budget

The federal budget includes nearly 175 trust funds, although fewer than a dozen account for the vast share of trust fund dollars. Among the largest are the two Social Security trust funds (the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund) and the funds dedicated to civil service retirement, Hospital Insurance (Part A of Medicare), and military retirement (see Table 1-6). Trust funds have no particular economic significance. They do not hold separate cash balances; instead, they function primarily as accounting mechanisms to track receipts and spending for programs that have specific taxes or other revenues earmarked for their use.

When a trust fund receives payroll taxes or other income that is not currently needed to pay benefits, the Treasury credits the fund and uses the excess cash for other government purposes. As a result, the government borrows less from the public than it would otherwise. The process is reversed when revenues for a trust fund program fall short

of its expenses. In that case, the government raises the necessary cash by increasing taxes, reducing spending, or borrowing more than it would otherwise.

Including the cash receipts and expenditures of trust funds as well as of other federal programs in the budgetary totals is useful for assessing how federal activities affect the economy and capital markets. Thus, CBO, the Office of Management and Budget, and many other fiscal analysts focus on the total deficit or surplus rather than on the deficit or surplus without particular trust funds.

In CBO's current baseline, trust funds as a whole are projected to run a surplus of $242 billion in 2005. That balance is somewhat misleading, however, because trust funds receive much of their income in the form of transfers from other parts of the budget. Such intragovernmental transfers reallocate costs from one section of the budget to another; they do not change the total deficit or the government's borrowing needs. Consequently, they have no effect on the economy or on the government's future ability to sustain spending at the levels indicated by current policies.

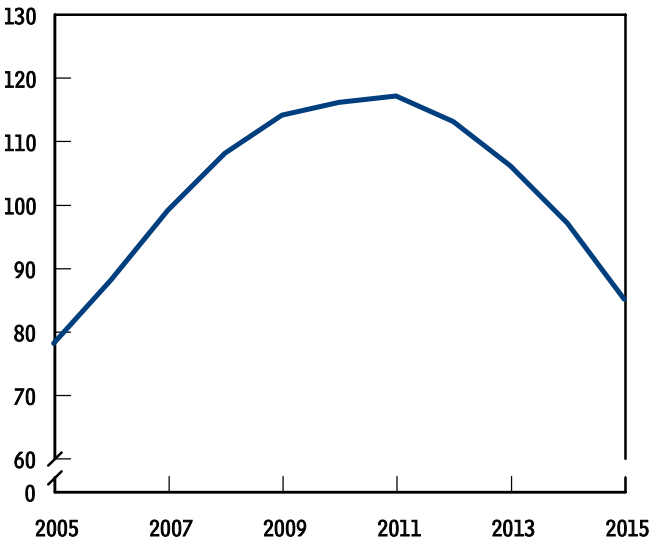
For 2005, those intragovernmental transfers are estimated to total $406 billion. The largest involve interest credited to trust funds on their government securities ($161 billion in CBO's projections), transfers of federal funds to Medicare for Supplementary Medical Insurance ($114 billion), contributions by government agencies to retirement funds for their current and former employees ($48 billion), and payments from the general fund to Social Security ($14 billion). With intragovernmental transfers excluded and only income from sources outside the government counted, the trust funds as a whole are projected to run a deficit throughout the projection period, growing from $164 billion in 2005 to $487 billion in 2015.

Although the budgetary impact of the aging of the baby-boom generation will not be fully felt during the current projection period, CBO's baseline provides initial indications of the coming budgetary pressures. Charting the differences over the next 10 years between projected receipts and outlays for the Social Security trust funds (excluding intragovernmental interest payments) illustrates those pressures. Receipts are projected to exceed expenditures in each year of the period, but under current policies, the amount by which they do so will decline from more than $100 billion between 2008 and 2013 to about $85 billion in 2015 (see Figure 1-6). At that point, Social Security outlays will be growing by about 6 percent per year, but noninterest receipts will be growing by about 4.5 percent. Thus, in CBO's baseline projections, the capacity of the Social Security trust funds to offset some of the net deficit in the rest of the budget—as they do now—will begin to dwindle during the coming decade. Shortly thereafter, Social Security is projected to begin adding to deficits or reducing surpluses.

**Figure 1-6.**

## Annual Social Security Trust Fund Surpluses, Excluding Interest

(Billions of dollars)




Source: Congressional Budget Office.

CHAPTER

# 2

# The Economic Outlook

The Congressional Budget Office forecasts that in 2005 and 2006, the U.S. economy will continue to expand at a healthy pace. Although investment by businesses is not expected to grow as rapidly as it did in 2004, such spending will probably still lead the economy's continuing expansion. Moreover, the caution that has characterized firms' decisionmaking over the past three years appears to be dissipating, and businesses seem to be having greater difficulty meeting increases in demand with their current workforce. As a result, hiring should accelerate. Productivity growth, which has been exceptionally strong since 2001, is expected to slow relative to its rate in the recent past; nevertheless, CBO anticipates that such growth will continue at a pace that is similar to its long-run average. Over the 2005-2015 period, real (inflation-adjusted) gross domestic product is expected to expand at an average annual rate of 3.1 percent.

A variety of factors, however, could lead to growth over the next 10 years that differs from CBO's best estimate. Cyclical factors—those deriving from the business cycle—are one potential source of risk to the outcomes that CBO envisions. Others include the confidence of businesses and investors, the growth of foreign economies, and the level of stock prices, each of which could be more or less buoyant than CBO expects. Beyond those risks, the accuracy of CBO's forecast of conditions over the next two years is subject to the uncertainty that surrounds the economy's response to world energy prices, the war on terrorism, the exchange value of the dollar, and events elsewhere in the world.

Looking to the medium term (from 2007 to 2015), productivity could continue to grow rapidly, permitting greater growth of output, income, and profits. Alternatively, productivity could grow at a below-average rate over the next few years, reversing its extraordinary recent advances and resulting in a lower level of GDP and income than CBO now anticipates.

## Overview of CBO's Two-Year Forecast

The economy is in the midst of a business-cycle expansion with solid gains expected in output, employment, and income. Growth of real GDP was an estimated 3.9 percent in 2004 (measured on a fourth-quarter-over-fourth-quarter basis), slightly slower than the 4.4 percent rate posted in 2003. But businesses appear to have thrown off some of the caution that marked the recovery from the 2001 recession and the subsequent expansion, and in the latter part of 2004, the growth of employment in particular picked up noticeably. In addition, investment by businesses swelled, rising from its 9 percent annual rate of increase in 2003 to a pace of nearly 12 percent in 2004. Those trends portend further growth during the near-term forecast period.

Although real GDP during the past two years grew at a rate faster than its historical trend, a considerable amount of "slack," or excess capacity, remained in the economy at the end of 2004, leaving room for further growth without increasing inflationary pressures. Thus, CBO expects that during the forecast period, GDP will grow faster than potential GDP, rising at a rate of about 3.8 percent, on average, before slowing during the 2007-2015 period to a pace of 2.9 percent (see Table 2-1).[1] In that projection, the gap that exists between GDP and CBO's estimate of potential GDP is largely closed by the end of 2007. CBO does not attempt to predict the course of the business cycle beyond the two-year forecast horizon. Consequently, once that output gap has closed, GDP is projected to grow at the same rate as potential GDP.

As the gap between GDP and potential GDP is eliminated, the rate of unemployment will decline from

1. Potential GDP is an estimate of GDP that excludes business-cycle fluctuations. It is the level of real GDP that corresponds to a high rate of resource (labor and capital) use.

**Table 2-1.**

## CBO's Economic Projections for Calendar Years 2004 to 2015

| | Estimated | Forecast | | Projected Annual Average | |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 to 2010[a] | 2011 to 2015[b] |
| Nominal GDP (Billions of dollars) | 11,730 | 12,396 | 13,059 | 15,940 | 19,861 |
| Nominal GDP (Percentage change) | 6.6 | 5.7 | 5.3 | 5.1 | 4.5 |
| Real GDP (Percentage change) | 4.4 | 3.8 | 3.7 | 3.3 | 2.7 |
| GDP Price Index (Percentage change) | 2.1 | 1.8 | 1.5 | 1.8 | 1.8 |
| Consumer Price Index[c] (Percentage change) | 2.7 | 2.4 | 1.9 | 2.2 | 2.2 |
| Unemployment Rate (Percent) | 5.5 | 5.2 | 5.2 | 5.2 | 5.2 |
| Three-Month Treasury Bill Rate (Percent) | 1.4 | 2.8 | 4.0 | 4.6 | 4.6 |
| Ten-Year Treasury Note Rate (Percent) | 4.3 | 4.8 | 5.4 | 5.5 | 5.5 |
| Tax Bases (Percentage of GDP) | | | | | |
| Corporate book profits | 8.4 | 10.7 | 9.4 | 8.7 | 8.3 |
| Wages and salaries | 45.6 | 45.7 | 45.8 | 45.9 | 45.9 |
| Tax Bases (Billions of dollars) | | | | | |
| Corporate book profits | 984 | 1,331 | 1,222 | 1,349 | 1,635 |
| Wages and salaries | 5,346 | 5,665 | 5,979 | 7,317 | 9,096 |

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Notes: Percentage changes are year over year.

Year-by-year economic projections for calendar years 2005 through 2015 appear in Appendix E.

a. For projections in billions of dollars, the level is that in 2010.

b. For projections in billions of dollars, the level is that in 2015.

c. The consumer price index for all urban consumers.

5.4 percent at the end of 2004 to 5.2 percent in 2005 and 2006, CBO forecasts. During the 2007-2015 period, the rate of unemployment is expected to average 5.2 percent.

According to CBO's forecast, inflation will be lower in 2005 and 2006 than it was in 2004. A surge in energy prices, along with an acceleration in the cost of shelter and in used car prices, caused a spike in inflation in 2004 as measured by the consumer price index for all urban consumers (CPI-U); CBO, however, does not expect that increase to feed into core inflation (inflation excluding changes in prices for food and energy). In fact, energy prices are likely to fall this year, according to many analysts. CBO projects that consumer prices will rise by 2.4 percent in 2005 and 1.9 percent in 2006; during the 2007-2015 period, CBO anticipates growth averaging 2.2 percent.

Interest rates are expected to move upward during the next two years, as the economy continues to grow and the Federal Reserve continues to move toward a more neutral monetary policy. CBO forecasts that the three-month Treasury bill rate will rise to about 2.8 percent in 2005 and 4 percent in 2006; thereafter, it is projected to average 4.6 percent, which is relatively low by historical standards. The estimated rise in the 10-year Treasury note's rate is somewhat smaller. That rate is projected to average 4.8 percent in 2005 and 5.4 percent in 2006 and then inch up to average 5.5 percent from 2007 to 2015.

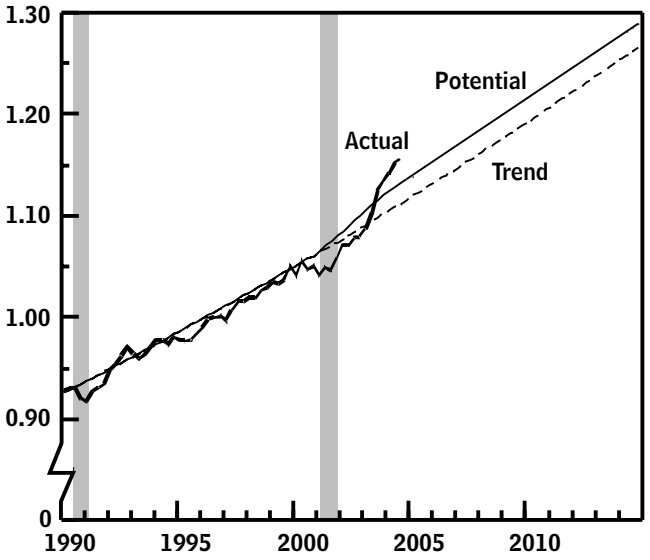
## The Importance of Productivity Growth for Economic and Budget Projections

Productivity has grown at an extraordinarily rapid pace in the past three years. Labor productivity, or output per

**Figure 2-1.**

## Total Factor Productivity

(Index, 1996 = 1.0)




Source: Congressional Budget Office

Notes: Total factor productivity is the average real output per unit of combined labor and capital inputs.

The data are adjusted to exclude the effects of methodological changes in the measurement of prices.

hour worked, rose at an average annual rate of 4.4 percent during the three-year period ending in the third quarter of 2004, well above its post-World War II average of 2.3 percent. Similarly, total factor productivity (TFP), or output per unit of labor and capital combined, grew at an average annual rate of 3.5 percent during the same period—which is about 2.2 percentage points above its trend rate of growth (see Figure 2-1).

The future course of productivity plays an important role in CBO's economic outlook, largely because it underlies CBO's estimate of the potential output of the economy. That estimate is important in two ways: it indicates how long the current relatively rapid growth of GDP can continue without running into capacity constraints, and it drives CBO's projections of GDP and tax bases over the next 10 years. Indeed, each increase of a tenth of a percentage point in the growth rate for labor productivity or TFP, if cumulated over that period, would raise the level of GDP in 2015 by roughly 1 percent, or about $200 billion.

Rapid productivity growth also has implications for the outlook for near-term inflation and employment through its effect on the output gap and excess capacity. The output gap (the percentage difference between GDP and potential GDP) is a summary indicator of the slack that exists in the economy. Strong productivity growth since 2001 has boosted CBO's estimate of potential output, which has, in turn, prevented the moderate growth of real GDP from shrinking the output gap by as much as might have been expected on the basis of historical patterns. Hence, a fair amount of slack—1.6 percent—still existed during 2004, which has kept inflation tame and allowed the Federal Reserve to keep interest rates lower than would otherwise have been the case.

Fast growth of productivity also explains how solid growth of output has been possible even though the rise in employment during the current business-cycle expansion has been unusually small. After declining modestly during the recession, real GDP has grown since 2001 at an average annual rate of 3.3 percent, a fairly typical pace in past business cycles. Apparently, however, firms were reluctant to hire workers (and purchase structures and equipment) during that period and focused instead on increasing efficiency. As a result, businesses have been able to meet modest increases in demand with existing labor and capital, and productivity growth has surged.

Going forward, it is difficult to project confidently whether the faster pace of productivity growth will continue because analysts have no compelling explanation for the acceleration. A number of hypotheses have been suggested to explain the speedup in growth; they include the possibility that businesses might have hesitated to hire more workers, perhaps because of geopolitical uncertainties arising from the threat of terrorism or because of strong competition from abroad, and focused instead on improving productivity. Other possibilities center on the idea that the surge in productivity is a delayed payoff to the investments that firms made in information technologies (IT) and other capital goods during the late 1990s. (Analysts suggest that the delay might have ensued either because there were unmeasured costs for absorbing new capital goods or because IT investments are fundamentally—but gradually—transforming the way that the economy works.) To decisively accept or reject any such conjecture is impossible, given the limited amount of data available from such a brief period of observation.[2]

2. For more discussion of the speedup in productivity growth, including possible causes, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005-2014* (January 2004).

In CBO's view, three broad outcomes are possible:

- The productivity surge might be reversed. In that scenario, a period of below-trend (or negative) growth would ensue, bringing the level of productivity back to the path it had been following before the period of faster growth. (That is what happened after surges in productivity in 1983 and 1992.)

- The gains thus far might persist as an upward shift in the future path of productivity, but productivity growth would return to its previous pace. The faster growth from the recent period would not be reversed, but going forward, productivity would "jump off" from the new higher level.

- Future rates of productivity growth might continue to exceed CBO's previous estimate of growth based on productivity's historical trend. In that case, productivity levels in future years would exceed CBO's previous projection by an ever-widening margin. Roughly speaking, that scenario mirrors what happened between the early 1970s and the mid-1990s but moves in the opposite direction. (Starting in about 1973, productivity growth slipped from the 2.8 percent average pace it had posted during the 1950s and 1960s and grew at an average annual rate of 1.4 percent until about 1995.)

Also possible, of course, is that productivity growth during the period since 2001 will look entirely different after the underlying data have been revised in the future—a common occurrence as more information becomes available. Growth could be revised upward or, as happened with the data for the late 1990s, downward (see Box 2-1).

CBO has chosen to adopt the middle ground—that the recent upturn in productivity growth reflects a transition to a permanently higher level of productivity in the economy. As a result, CBO has raised its estimate of the growth of potential TFP during the 2001-2003 period by an average annual rate of 0.6 percentage points. That adjustment to potential TFP growth accounts for about half of the deviation during 2004 of actual TFP from CBO's estimate of the trend level.[3] In the future, TFP growth is assumed to revert to the slower pre-2001 rate, leaving the level of potential TFP permanently higher than it would have been had its growth not accelerated during the 2001-2003 period.

## The Outlook for 2005 and 2006

CBO forecasts that during 2005 and 2006, the economy will continue to expand at a healthy pace. Businesses are expected to respond to stronger demand by increasing their spending on capital assets and by hiring more workers, which should in turn support further boosts in demand. Productivity growth over the same period is likely to abate somewhat and interest rates to climb gradually, while inflation will moderate, in CBO's estimation, after the spike in 2004 induced in part by the jump in energy prices.

### The Business Sector

The business sector comprises firms that produce goods and services. Firms decide which workers (and how many of them) to hire, how much investment in capital goods to undertake, whether to pursue sales in other countries, and how to most efficiently combine their labor and capital to maximize their profits. Of those decisions, investment spending—firms' expenditures on equipment, software, structures, and inventories—has the most direct effect on the growth of output. Although such investment makes up a relatively small share of GDP—roughly 11 percent in recent years—it is quite volatile and therefore disproportionately affects changes in GDP growth.

Higher levels of investment by businesses will be an important source of growth during the next two years, in CBO's estimation. Firms will probably be unable to meet increases in demand by cutting costs and increasing efficiency. Instead, they are expected to expand capacity by purchasing capital assets and hiring more workers.

**Business Fixed Investment.** After a prolonged decline between the end of 2000 and the beginning of 2003, businesses' spending on structures and equipment grew robustly during the final three quarters of 2003 and in 2004 and should continue to contribute strongly to economic growth as the expansion continues. During the second half of 2004, real business fixed investment

3. CBO began including this adjustment in January 2004. For more details, see Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2005 to 2014*.

**Box 2-1.**

## Data Revisions and the Productivity Boom of the Late 1990s

During the late 1990s, economic growth in the United States was robust, the stock market was booming, investment by businesses surged, and the rise in productivity appeared to be so strong that many observers declared that a new era of productivity growth had dawned. Since 2000, a number of revisions to the data used to calculate productivity have changed the view of its growth during the late 1990s—in particular, by trimming the pace of productivity expansion during the 1995-1999 period.

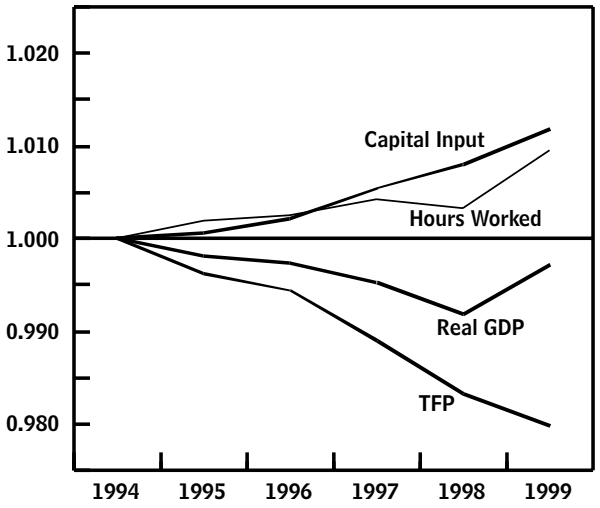
For example, when CBO estimates total factor productivity (TFP) during that period on the basis of currently available data, TFP grows at an average annual rate of 1.3 percent. However, when CBO calculates TFP using data that were available when it prepared its *Budget and Economic Outlook* for January 2000, the rate is 1.7 percent. Pushing the estimate lower have been revisions to the three data series that are used to compute TFP: specifically, growth in the number of hours worked and in capital services (the productive services provided by the economy's capital stock) has been revised upward, and growth of real GDP has been revised downward (see the figure).

Those revisions were made gradually, none was especially large, and the cumulative effect of all of the revisions was to lower the level of TFP by 2 percent in 1999. The biggest revision to real GDP occurred between the publication of CBO's January 2001 and January 2002 *Budget and Economic Outlook* reports, when the Bureau of Economic Analysis released the results of its annual revision to the national income and product accounts. That revision reduced the average annual rate of growth of real GDP in the nonfarm business sector during the 1995-1999 period by nearly a tenth of a percentage point. The largest upward revision to the category of labor hours worked in the economy occurred last August—too late to be incorporated in CBO's economic forecast for the September update of its January 2004 outlook. The Bureau of Labor Statistics released a data series that reflected new estimates of hours worked by nonproduction and supervisory workers and boosted the pace of labor-hour growth during the 1995-1999 period by more than a tenth of a percentage point.

Although the revisions to the data underlying the productivity statistics are significant, there is still a substantial step-up in growth for TFP during the late 1990s when compared with the preceding period. The growth rate calculated for TFP during the 1995-1999 period—1.3 percent—is considerably higher than the average growth rate for the 1974-1994 period, when TFP grew at an average annual pace of 0.8 percent. The revisions to hours worked and real GDP described above also affect labor productivity. When calculated using data that were available in January 2000, labor productivity grows at an average annual rate of 2 percent during the 1995-1999 period, down from 2.2 percent using currently available data. Like TFP, labor productivity growth picks up during the late 1990s, even after the revisions: average annual growth during the 1995-1999 period is about 0.6 percentage points faster than it was from 1974 to 1994.

**Revisions to Late 1990s Data for Key Inputs to Potential Output**

(Index, 1994 = 1.0)

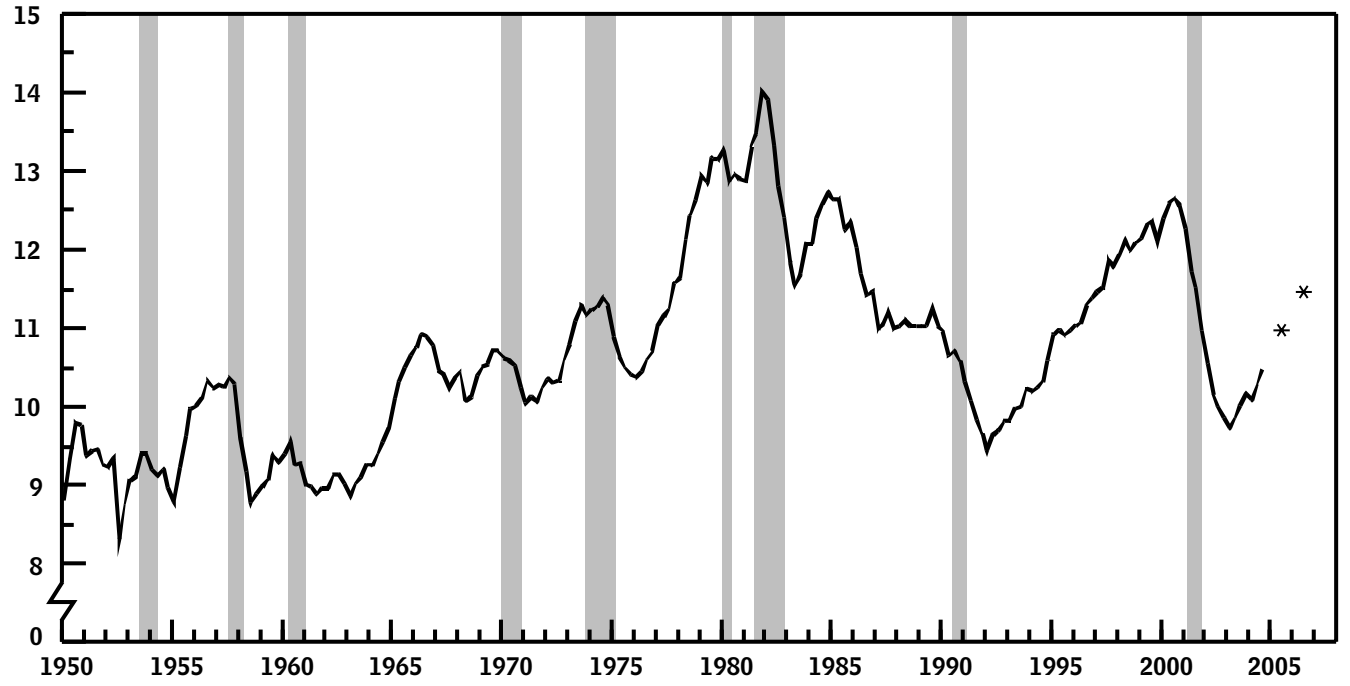



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

**Figure 2-2.**

## Business Fixed Investment

(Percentage of potential GDP)




Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: * = CBO's forecast for 2005 and 2006.

climbed at an estimated rate of more than 15 percent measured on an annual basis—well above its postwar average of 5 percent or its average annual rate of 9 percent during the boom in investment of the late 1990s. Yet despite that vigorous growth, real business fixed investment at the end of 2004 had only just regained the ground it had lost during the 2001 recession and the sluggish recovery that followed. Consequently, CBO expects that during the next two years, the pace of firms' investment spending will remain above its long-run rate.

Real business fixed investment fell by 15.1 percent between the beginning of the recession (in the first quarter of 2001) and the first quarter of 2003. As a share of potential GDP, that drop was sharper and more long-lasting than such declines in past business cycles (see Figure 2-2). In the first quarter of 2003, eight quarters after the business cycle's peak, real investment in equipment, software, and structures was still 14 percent below its peak value. On the basis of past patterns, it would have been expected by then to have recovered all of its losses.

As the economy recovered from the 2001 recession, however, demand for goods and services expanded less rapidly than businesses' ability to produce them. The reason, for the most part, was that the growth rate of total factor productivity was exceptionally high, which allowed firms to meet increased demand without the hiring or capital expenditures that would be typical during the early phase of a business-cycle expansion. In addition, a surge in investment spending during the late 1990s, especially for telecommunications equipment, apparently left many industries with more capacity than they needed. Consequently, even though real GDP grew at moderate rates in 2002 and 2003, firms' spending for capital equipment and the growth of employment lagged behind the rise in output.

Both investment and hiring improved in 2004, indicating that the factors tending to restrain firms' spending had weakened. Real business fixed investment grew by an estimated 11 percent last year, suggesting that businesses were concerned about their ability to meet expected increases in demand with existing capacity and expected productivity growth. Although labor productivity rose at

a fairly brisk pace in 2004—about 3 percent—CBO expects that labor productivity growth will slow toward its long-term trend in 2005 and 2006. At the same time, a steady rise in consumption by households and governments will encourage businesses to spend more on investment, which CBO estimates will grow by about 10 percent in real terms during 2005 and 2006.

A variety of indicators other than business investment suggest that the confidence of businesses improved during 2004. For example, the Business Roundtable, an association of chief executive officers of leading U.S. corporations, surveyed up to 160 member companies about the economic prospects for the next six months and reported an overall index averaging 98 in 2004 (a value above 50 indicates expansionary conditions) compared with a value of 68 in 2003. In a key portion of the survey that measures confidence, an average of 88 percent of respondents to the association's four quarterly surveys of 2004 expected their firm to increase sales in the next six months—compared with 72 percent during 2003.

Another measure, based on work by the Conference Board, showed similar results but also some divergence. (The Conference Board is a global business membership organization that conducts research and forecasts and assesses economic trends.) The measure, which used the board's CEO Confidence Survey, was also stronger in 2004 than in 2003, averaging 67 last year versus 62 in the previous year. Unlike the Business Roundtable's survey, however, the Conference Board's measure suggests that confidence waned over the course of 2004 after a robust first quarter.

Changes in tax laws aided investment in 2004 but will no longer do so in 2005 and beyond. The Job Creation and Worker Assistance Act of 2002 (JCWAA) contained incentives to bolster businesses' spending on equipment and structures by temporarily increasing the fraction of new investment that firms could "expense" (deduct from their taxable income immediately rather than over time). The Jobs and Growth Tax Relief Reconciliation Act of 2003 expanded those incentives by allowing firms, through the end of 2004, to expense 50 percent of the value of new equipment and of some structures in the tax year in which the property was acquired. JGTRRA also increased, through 2005, the limit on small businesses' expensing of new depreciable assets—and that limit was extended through 2007 by the American Jobs Creation Act of 2004. On balance, those incentives boosted investment in equipment slightly in 2004 but will have little effect in 2005 and 2006.

Current financial conditions are favorable for businesses that seek to invest. Firms' high levels of corporate profits and retained earnings (the portion of profits that is not paid to shareholders as dividends) since the recession's end in 2001 should help businesses finance their capital spending from internal funds. Aided in part by the accelerated expensing provided by JCWAA and JGTRRA, firms' retained earnings reached an estimated 4 percent of potential GDP during 2004, a share not matched since the 1960s (see Figure 2-3). Corporate profits and retained earnings are not expected to remain at such elevated levels, though—partly because almost all of the expensing provisions in JGTRRA expired at the end of 2004 and partly because employers are expected to increase their contributions to their defined-benefit pension plans, especially in 2006 (see Appendix D).

In the near term, firms will continue to use retained earnings to underpin their investment spending. And if they need to turn to outside sources of financing, they will find that their costs for securing external capital will not have increased dramatically. Short-term interest rates rose somewhat during the second half of 2004, but businesses' spending on structures and equipment responds more to changes in long-term than in short-term rates, and long-term rates changed little over the year. Moreover, gains in the stock market last year mean that equity financing has become cheaper than it was in 2002 and 2003.

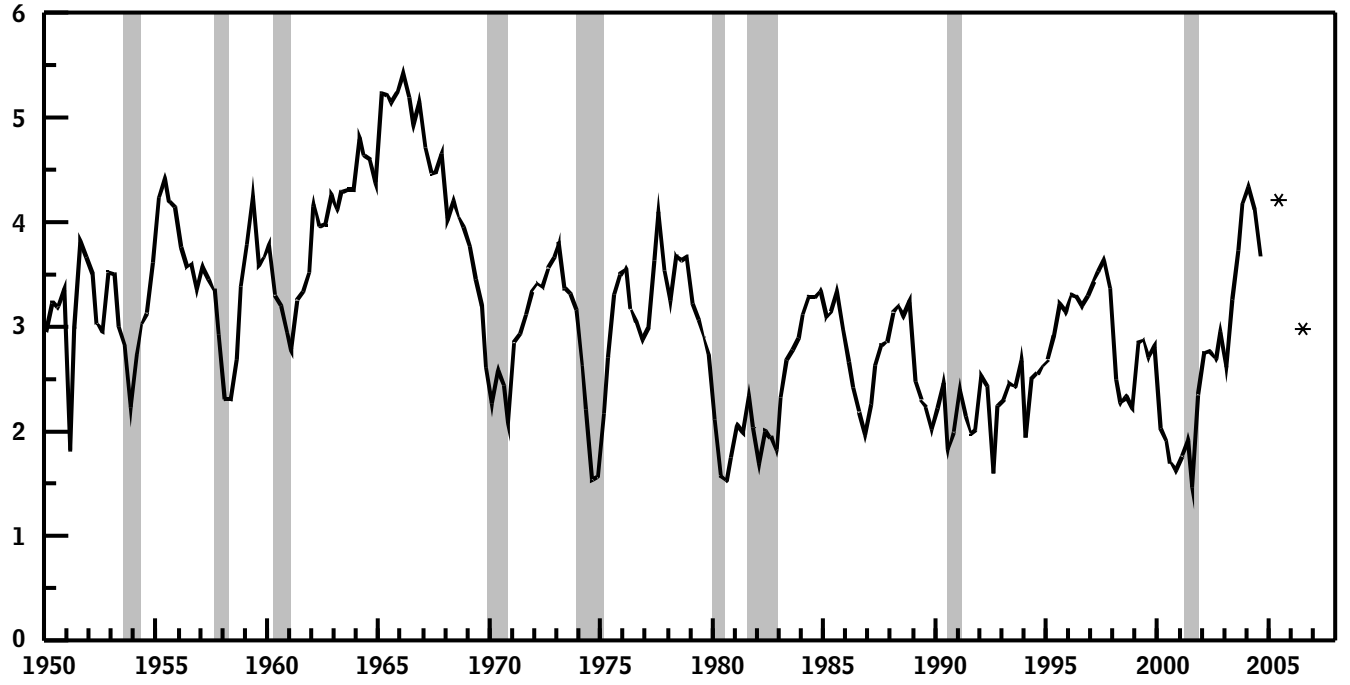
CBO expects that solid growth in the demand for output, combined with healthy financial conditions, will allow businesses' investment spending to continue to grow at a relatively fast pace during 2005 and 2006. In CBO's forecast, real investment in producers' durable equipment and software grows at an average annual rate of 10 percent during 2005 and 2006, whereas firms' spending for nonresidential structures, which began to rise in 2004, is slated to grow at an average annual rate of 4 percent during the two-year forecast period.

Despite the signs that businesses appear ready to invest more, however, actual outcomes remain uncertain. If, for example, the rate of growth of productivity continues to exceed its potential rate, firms could decide to meet future increases in demand with existing capacity and thus would not need to boost investment by as much as CBO

**Figure 2-3.**

## Corporate Retained Earnings

(Percentage of potential GDP)




Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: Retained earnings are the portion of profits not paid to shareholders as dividends.

* = CBO's forecast for 2005 and 2006.

envisions. Alternatively, other components of demand could grow more or less vigorously than CBO has forecast, which would lead to a correspondingly stronger or weaker course for investment. Another possibility is that future innovations may require firms to make new investments. (One example of such a change was the commercial development of the Internet, which required substantial investments by firms during the 1990s.) If such circumstances arise, investment spending by businesses may be much greater than CBO has foreseen.

**Inventory Investment.** The recent pattern of investment in inventories also suggests that businesses have become more confident about their economic prospects. As demand has picked up, so too has the building of inventories. Accumulation accelerated in 2004—inventories rose by an estimated $40 billion—after a period of sluggishness in 2003, when firms drew down their stocks. As with fixed investment, the pickup in spending on inventories has lagged behind economic growth during the past three years. Now, though, the strong demand forecast for 2005 and 2006, combined with a fairly lean stock of inventories, is expected to propel inventory investment to about $80 billion in 2005 and $70 billion in 2006.

### The Household Sector

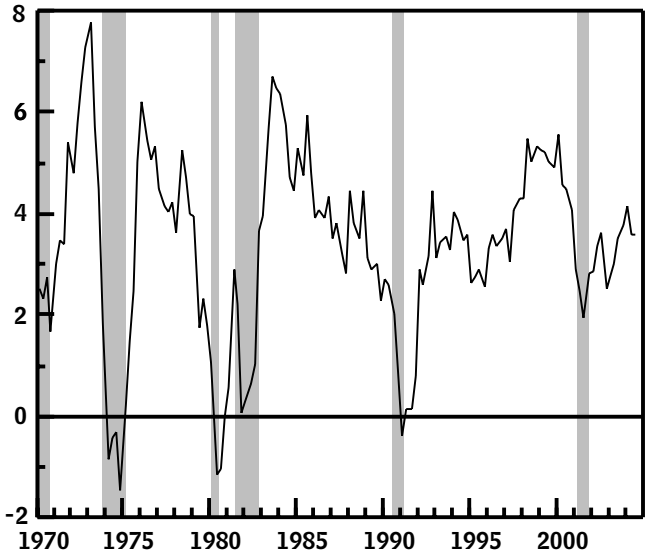
The household sector consists mainly of individuals and families who supply labor and decide how to divide their income between consumption and spending—and then choose which goods and services to purchase. Households' spending composes a large share of GDP—about 70 percent, on average, during the past five years. Households are also the main force behind residential investment, which makes up another 5 percent of GDP.

Spending by the household sector was a bright spot during the 2001 recession and subsequent recovery, supporting overall growth when other sectors, such as business investment and net exports, did not. Real consumer spending, for example, slowed but did not decline during the recession: it grew at an estimated average annual rate

**Figure 2-4.**

## Real Personal Consumption Expenditures

(Percentage change from previous year)




Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

of 3.3 percent during the 2002-2004 period, which is not too different from its long-run average rate of 3.6 percent (see Figure 2-4). Real housing investment was also relatively robust in the past recession, as compared with previous downturns, and remained quite strong during the recovery. Policy actions contributed to those healthy outcomes, as the Federal Reserve's accommodative monetary policy lowered financing costs for housing and durable goods and expansionary fiscal policy cut personal taxes. Last year, real consumer spending grew by an estimated 3.6 percent (measured on a fourth-quarter-over-fourth-quarter basis), and real residential investment grew at a solid 5.5 percent rate.

CBO believes that the household sector will continue to support the growth of real GDP in the next two years. The fundamental elements for an ongoing rise in consumer spending are in place: households' net worth has continued to improve; the recent gains seen in employment and income are likely to continue; and the household sector as a whole faces few financial difficulties. Nevertheless, an expected upturn in interest rates is likely to slow the growth of real consumer spending a bit this year and cause a modest decline in real residential investment.

The main risk to the prospect of continued robust spending by households is a stalling of employment and hence of growth in incomes. Another risk is the possibility of a sharp decline in the prices of houses, which are at a high level relative to incomes (and the general price level). However, a broad-based decline in housing prices seems unlikely.

**Employment.** CBO expects that conditions in the labor market will continue to improve as the economy expands in 2005 and 2006. Growth of the labor force is likely to accelerate, in CBO's view, and hiring to expand at an even faster rate, because firms will be unable to meet expected increases in demand through productivity growth. But the growth of employment is likely to remain slower than it would typically be in an expansion, and CBO forecasts that the unemployment rate will fall only slightly—to 5.2 percent—in 2005.

The level of employment dipped from the end of the 2001 recession until mid-2003, when it bottomed out and began a rebound that continued in 2004. Businesses added more than 2.1 million jobs last year, as measured by the Bureau of Labor Statistics' (BLS's) payroll survey, boosting employment by 1.6 percent over the four quarters of 2004. Employment as measured by BLS's household survey presents a slightly more optimistic picture of the labor market. According to the household survey, employment started growing earlier than the payroll measure indicated, and it increased steadily over the past two years, climbing by 1.0 million jobs in 2003 and about 2.2 million in 2004.[4]

The stronger gains in employment last year are reflected in the drop in the unemployment rate, which declined by 0.5 percentage points to 5.4 percent. Ordinarily, that low a rate would suggest that the labor market had tightened appreciably. However, the rate probably understates the market's current degree of slack because the rate of labor force participation—the share of the population ages 16 and older who are either employed or looking for work—has been falling since 2000. After a long-running rise that started in the early 1960s, the labor force participation rate peaked at 67 percent of the civilian population in the first quarter of 2000 and has since declined to 66 percent. That drop implies that the labor force has 2.2 million

4. Those figures were adjusted by BLS to smooth out the effects of revisions to the underlying population estimates in January 2003 and January 2004.

fewer workers than it would have had if the participation rate had not declined. CBO anticipates that in the coming years, the participation rate will recover somewhat as the continuing creation of jobs draws many of those workers back into the labor force.

Some indicators of businesses' plans for hiring suggest that firms are likely to continue to add jobs at a rate similar to the average since 1970. An index of hiring demand calculated by the Internet-based employment agency Monster.com, although too new to interpret with any precision, indicates that the availability of jobs is greater than it was a year ago. Moreover, the BLS's Job Openings and Labor Turnover Survey shows recent gains in both the rate of hiring and the number of job openings. In addition, a recent survey of employers' hiring plans by Manpower, Incorporated, a provider of temporary workers, suggests that hiring gains will continue in early 2005.

**Income.** CBO expects that more substantial growth in employment will provide—as it did last year—the basis for a solid rise in wages and salaries in 2005 and 2006 (see Figure 2-5). In 2004, real wages and salaries grew by an estimated 2.6 percent after inching up 0.6 percent in 2003; the pace of growth this year is expected to pick up to about 4 percent before tapering off slightly next year. Also boosting real incomes slightly this year, in CBO's view, is a modest decline in energy prices, which will lower the overall rate of inflation in consumer prices.

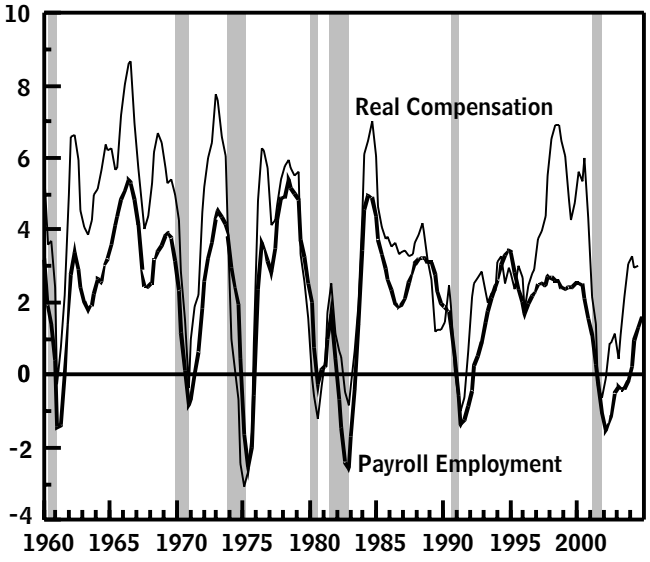
Although the growth of wages and salaries is expected to quicken in 2005, the growth of disposable (after-tax) personal income is likely to remain relatively steady. During the past few years, cuts in personal taxes raised disposable income, even though the growth of wages and salaries was fairly listless. By contrast, the source of growth in disposable income in the future is likely to be a moderate rise in employment growth.

In CBO's estimation, a modest decline in energy prices will boost real disposable personal income this year by a small amount. Increases in the price of both crude oil and natural gas contributed to the hike in consumer energy prices last year, which reduced the rate of growth of real disposable income. After rising only slightly in the second half of 2003, the price index for consumer energy products shot up at an average annual rate of more than 26 percent in the first half of 2004; in the third quarter, it climbed by an additional 4 percent. This year, CBO assumes, refiners' acquisition cost of crude oil will fall from about $45 per barrel in the fourth quarter of 2004 to just under $40 by the fourth quarter of 2005.

**Figure 2-5.**

## Payroll Employment and Real Labor Compensation

(Percentage change from previous year)




Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

**Households' Financial Health.** Households' finances are in good shape, having turned around in 2003 and strengthened in 2004. Consequently, they should not hinder spending. Despite a flat stock market for most of the year, the net wealth of households essentially rose at the same rate as disposable income during 2004 because their real estate wealth posted a strong advance. Moreover, the household sector as a whole does not appear to be suffering from financial stress. Although households' borrowing grew rapidly last year, the share of disposable income they used to service debts rose only slightly, and the share claimed by financial obligations declined through the third quarter of last year. In addition, delinquency rates at commercial banks on credit cards, other consumer loans, and residential real estate all declined during 2004.

**Housing.** Investment in housing, propelled by historically low interest rates on home mortgages, has been an important source of strength in the economy in the past few

years. Now, however, in CBO's view, the housing market is likely to cool in 2005 and 2006 in the face of a rise in mortgage interest rates. During 2004, housing investment surged to near-record levels, reaching 5.7 percent of GDP in the middle of the year; single-family housing starts and sales of new and existing homes also reached record highs. But mortgage interest rates are likely to rise as the economy keeps expanding and the Federal Reserve continues to push the federal funds interest rate, its main policy tool, back toward a more neutral level.[5]

The prices of houses registered another strong advance last year. According to the Office of Federal Housing Enterprise Oversight (OFHEO), the price index for single-family homes rose by 13 percent in the year ending in the third quarter of 2004, a jump that is considerably above the average annual rise of about 7 percent posted during the previous two years. According to OFHEO, a part of the step-up in growth last year may reflect the fact that appraised values for houses that were undergoing refinancing have "caught up" with previous price increases in the real estate market.[6] Apparently, appraisals for refinancings may not have kept pace with market prices during the previous one or two years, when refinancing activity was at record levels. Now that such activity has abated, appraisals for refinancings better reflect current market prices, in OFHEO's view.

Some analysts worry that the continued rise in the prices of houses reflects a market that has been seized by a speculative frenzy that could lead to a price collapse. Such an outcome would hurt household wealth and hence spending. Research indicates, however, that the rise in housing prices in recent years for the nation as a whole reflects positive fundamental factors, such as rising personal income and declines in mortgage interest rates, rather than speculative expectations of future increases in prices.[7] In CBO's estimation, a general collapse of prices for houses is unlikely because stronger income growth in the next two years will probably counteract the anticipated rise in mortgage interest rates. Prices could fall in some areas—particularly parts of the Middle Atlantic, New England, and Pacific regions—where prices have risen much faster than in other parts of the country. However, any such declines are unlikely to present a serious risk for the nation as a whole.

### Imports, Exports, and the Value of the Dollar

In 2004, the United States increased its imports by more than it increased its exports, so the nominal balance of trade—U.S. exports minus imports—worsened. During the past three years, that imbalance has widened by an estimated $230 billion in nominal terms, or about 2 percent as a share of GDP. However, in CBO's estimation, the decline will reverse in the near future. By 2006, the growth of exports is likely to outpace that of imports, and the balance of trade should begin to improve.

The projected improving trend in the trade balance largely reflects the expected decline of the dollar relative to the currencies of the United States' trading partners, especially those of Asian economies. The dollar has been falling for three years; since its peak in the first quarter of 2002, it has lost almost 14 percent of its value (see Figure 2-6). Such a decline should eventually improve the trade balance by making U.S. exports cheaper (in terms of foreign currency) and U.S. imports more expensive (in dollars). Nevertheless, the trade balance has continued to fall over the past three years despite the dollar's decline, for two reasons.

First, declines in the exchange value of the dollar typically take two to three years to exert their full effect on the trade balance. Initially, the dollar's decline will worsen the nominal trade balance because it raises the dollar price of imports, most of which are priced in foreign currencies, faster than it reduces the quantity of imports. Over time, however, the trade balance will improve as the increase in the value of exports and the decline in the quantity of imports dominate the rise in the price of imports. Thus, the lack of response of the trade balance to the dollar's decline since early 2002 partly reflects a continued adjustment to the rapid rise in the dollar's value during the 1995-2001 period.

Second, the fall of the U.S. currency has increased the dollar prices of imported goods by less than analysts had expected on the basis of past relationships. Although the dollar fell by about 14 percent during the past three years, import prices (other than for oil and computers) rose by

5. The federal funds rate is the interest rate that financial institutions charge each other for overnight loans of their monetary reserves.

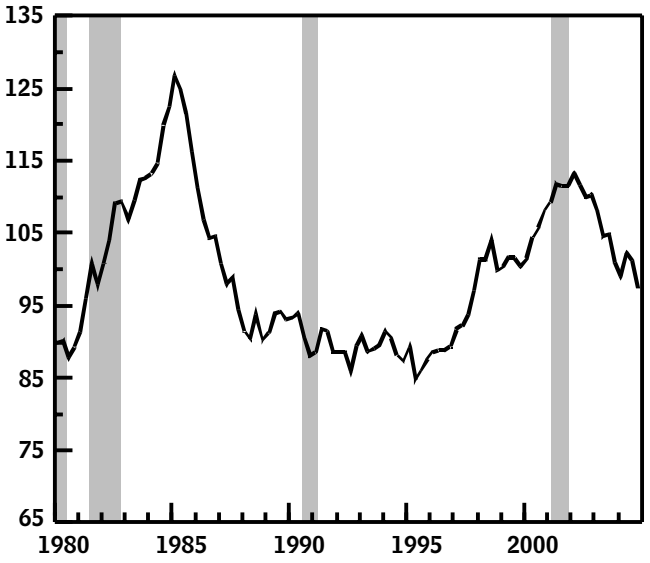
6. See Office of Federal Housing Enterprise Oversight, "OFHEO House Price Index: House Price Gains Continue to Accelerate" (news release, December 1, 2004), available at www.ofheo.gov.

7. Jonathan McCarthy and Richard W. Peach, "Are Home Prices the Next 'Bubble'?" *Economic Policy Review*, Federal Reserve Bank of New York (December 2004), pp. 1-17.

**Figure 2-6.**

## Real Trade-Weighted Value of the U.S. Dollar

(Index, March 1973 = 100)




Sources: Congressional Budget Office; Federal Reserve Board.

Note: The real trade-weighted value of the U.S. dollar is a weighted average of the foreign exchange values of the dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

only 5 percent, which implies that producers abroad must have absorbed more of the effect of the exchange rate change than in the past. Presumably, the underlying reason is an increase in competition for the U.S. market. Over the past several years, the lackluster domestic demand in many industrialized nations suggests that the U.S. market has grown in importance for firms in other countries at the same time that the surge in U.S. productivity growth has boosted the competitiveness of U.S. products. Exporters in those industrialized countries may also be afraid that if they raise their dollar prices by too much, they will lose some of their share of the market to producers in the United States and to the Chinese, whose currency has not appreciated against the dollar.

Imports and exports also reflect other factors, notably the price of oil and the growth of incomes. (Income growth in the United States helps determine the demand for imports; income growth in countries that the United States trades with helps determine exports.) The sharp rise in oil prices since late 2003 slowed the decline in the trade deficit by raising the value of U.S. oil imports. CBO expects that oil prices will continue to fall from their peak in late 2004, which will help reduce the cost of such imports. Another factor that has been contributing to the trade balance's decline—stronger growth in the United States than in the countries that purchase its exports—is expected to play less of a role in the next few years, as the difference between the pace of growth here and abroad diminishes.

CBO's forecast of an improving trade balance, however, is subject to considerable uncertainty. If the economies of the United States' trading partners should falter or oil prices fail to decline as expected, the improvement in the trade balance could be delayed. CBO's forecast also incorporates the assumption that international investors (including governments) will continue to increase their holdings of U.S. assets. If, instead, those investors decided to reduce or simply not increase their holdings of dollar assets, the U.S. currency could fall more quickly than CBO anticipates—which would tend to raise both inflation and interest rates, at least temporarily, and slow economic activity. It would also, however, improve the trade balance more quickly, implying that foreign countries would bear some of the costs of that adjustment.

**Economic Conditions Abroad.** Forecasters in the private sector anticipate that the overseas economic recovery will continue, with solid growth and generally low inflation and interest rates. Among the United States' trading partners, economic growth picked up in 2004; during 2005 and 2006, it is expected to nearly keep pace with its long-run rate of roughly 4 percent. *Consensus Forecasts*, a survey of financial and economic forecasters, expects that growth among the countries that use the euro will equal 1.7 percent in 2005 and 2 percent in 2006.[8] Japan's economic recovery, which has been helped considerably by exports to China, should also continue. Canada, although fighting the drag caused by an appreciating currency, is also helped by high prices for commodities (including oil) and is expected to keep growing at a moderate rate.

Major developing countries have also grown at healthy rates. China, though it imports little from the United

8. Consensus Economics, Inc., *Consensus Forecasts, A Digest of International Forecasts*, published by Consensus Economics, Inc., (London: U.K., Consensus Economics, Inc., January 10, 2005).

States, makes a substantial contribution to regional economic activity, having grown 9 percent in real terms during 2003 and 2004. In Latin America as well, economies have rebounded. Mexico's has benefited from rapid economic growth in the United States, its largest trading partner, and from the increase in the price of oil. Brazil's economy, the largest in South America, expanded at an estimated rate of 5 percent during 2004 and is expected to grow by nearly 4 percent in 2005.

**The Current Account and the Exchange Value of the Dollar.** Although exchange rates are notoriously difficult to forecast, CBO expects that the exchange value of the dollar will decline during the next two years, largely because continued deficits in the nation's current account will raise net liabilities to foreigners to new highs. (The current account is a broad measure of U.S. transactions with the rest of the world. It includes not only the trade balance but also net investment income and net unilateral transfers.)[9] In CBO's view, investors will be less willing to add to their holdings of dollar assets at current exchange rates and interest rates.

Persistent current-account deficits have led to more-rapid accumulation of foreign-owned assets in the United States than of U.S.-owned assets abroad. Net liabilities to foreigners—the difference between U.S.-owned assets abroad and foreign-owned assets in this country—declined to an estimated -24 percent of GDP during 2004. By the end of 2006, such liabilities will have fallen to about -30 percent of GDP, CBO expects, even though the current-account deficit is forecast to stabilize during that time.

Investors may not be willing to hold that increased volume of dollar assets unless the rate of return they expect on those assets goes up. In principle, the expected rate of return can increase either as the dollar return on those assets (interest rates or the return on equities) goes up or as the dollar falls, making the assets cheaper. CBO anticipates that most of the adjustment will come as the dollar falls.

**Assessing the Risk of a Sharp Decline in the Dollar.** The extent of the U.S. current-account deficit and of the United States' net liabilities to foreigners has prompted concerns on the part of some analysts about the risk of a sudden and significant decline in the dollar. In that scenario, a sharp drop in the demand for assets denominated in dollars could cause an abrupt tumble in the dollar's value, which could disrupt the global economy by sharply raising inflation and interest rates in the United States, slashing the foreign-currency value of dollar-denominated assets that are owned by people in other countries, and crippling the competitiveness of foreign producers relative to manufacturers in the United States. More likely, however, in CBO's view, is an orderly decline in the dollar and little disruption to the U.S. economy, for the following reasons:

- The returns expected on investments in the United States remain higher than those available abroad, especially after adjusting for the risk of default. In part, that is because the outlook for the U.S. economy is brighter than the prospects for Japan and the countries that use the euro, which suggests that the return on U.S. portfolio assets, such as stocks and bonds, will exceed the return available in those countries. The expected rate of return on portfolio assets in some developing economies may surpass that in the United States, but it is also subject to much greater risk.

- Many countries that export to the United States have a strong incentive to minimize the potential damage to their own economies by preventing the dollar from falling too sharply. A large decline in the dollar's exchange rate would cut the value of many countries' reserves of foreign exchange—which are held largely in dollars—and it could also dampen the rate of economic growth in countries that send a large share of their exports to the United States. Moreover, as the major international reserve currency, the dollar's exchange value receives steady support from demand arising from its use as a medium of exchange for international transactions and from those who hold it as a precaution against the devaluation of their own currency.

- A plunge in the dollar's exchange rate would not tend to feed on itself as has sometimes occurred in past episodes involving depreciations of the currencies of developing countries. Most foreign assets owned by U.S. citizens, companies, and governments are denominated in the relevant local currency, whereas almost all U.S. liabilities to foreigners are denominated in dol-

9. Unilateral transfers are official and private payments from the United States to sources abroad and from sources abroad to the United States, in which the payments are not made in exchange for goods and services.

lars. Consequently, the dollar's depreciation automatically shrinks the value of U.S. net liabilities to foreigners, thereby removing some of the pressure for further depreciation. By contrast, many of the international liabilities of other countries, especially those of developing countries, are denominated in the currencies of their creditors. Hence, a decline in the exchange value of the countries' currencies increases the value of their net liabilities to foreigners—which, in turn, further depresses their currencies.

- The depreciation of the dollar will, over time, help boost U.S. net exports and thus economic growth. That positive aspect of a drop in the dollar's value also helps limit the extent of its fall.

### Monetary Policy and Financial Market Conditions

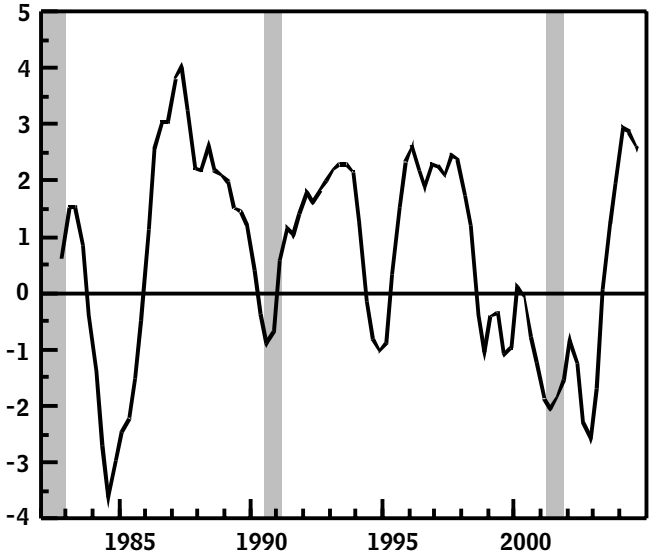
CBO expects that during the next two years, the Federal Reserve will continue to shift monetary policy away from the accommodative stance it has maintained since the 2001 recession and toward a more neutral position by raising its target for the federal funds rate, its primary policy instrument. Before the central bank began to boost the rate in June, it had been kept for a full year at the historically low level of 1 percent, a policy that was designed to achieve economic growth that could sustain itself without policy actions. Now that the economy appears to have found its footing, Federal Reserve officials have stated that they will raise the target rate at a measured pace and move monetary policy toward a neutral stance—one that is balanced between supporting economic growth and maintaining low inflation. That approach is seen by participants in the financial markets as allowing room for the Federal Reserve to quicken the pace of policy tightening if inflation surges or to delay interest rate increases if the economy stumbles. At the time that CBO's forecast was completed, the consensus among financial market participants was that the federal funds rate would reach 3.25 percent by August 2005. (In late December 2004, the target rate was 2.25 percent.)

An index of monetary and financial conditions compiled by the consulting firm Macroeconomic Advisers indicates that financial conditions are still adding a considerable degree of upward momentum to the growth of GDP, even after the hikes in short-term interest rates that occurred in 2004 (see Figure 2-7). At year's end, rates on corporate bonds, though slightly higher than the low levels (about 5.3 percent) seen briefly in early 2004, were still sufficiently low (about 5.5 percent) to encourage investment. Like other long-term rates, those on corporate bonds had weathered midyear jitters over whether the pace of the Federal Reserve's tightening would be rapid or relatively deliberate. (Rates rose to 6 percent before falling back.) Conditions have also continued to improve in the stock market, which is helping to restore household wealth. New public stock offerings by corporations have been one result of that more favorable climate, providing another source of funds for businesses' expansion.

**Figure 2-7.**

## Index of Monetary and Financial Conditions

(Percentage points of GDP growth)




Sources: Congressional Budget Office; Macroeconomic Advisers, LLC.

Notes: This index estimates how much financial markets contribute to the rate of growth of real GDP. It draws on statistical relationships between real GDP and financial variables such as interest rates, exchange rates, and equity values. When the index is positive, overall conditions in the financial markets are conducive to the growth of real GDP. When it is negative, overall financial market conditions are a drag on growth.

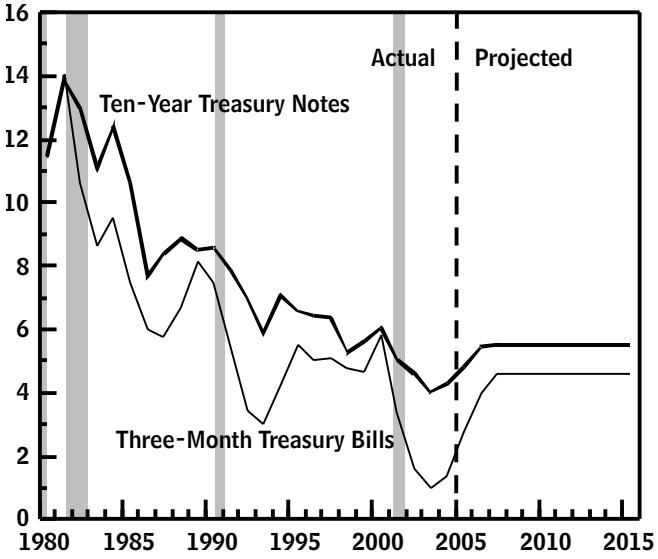
The last data point is the third quarter of 2004.

CBO forecasts that the rate on three-month Treasury bills will continue to climb as the federal funds rate rises. The rate on three-month bills, which stood at 2.2 percent at the end of 2004, is expected to average 2.75 percent and 4 percent in 2005 and 2006, respectively (see Figure 2-8). That forecast is on a par with expectations in financial

**Figure 2-8.**

## Interest Rates

(Percent)




Sources: Congressional Budget Office; Federal Reserve Board.

Note: All data are annual values.

markets about the direction of monetary policy. (Typically, the Treasury bill rate tends to rise and fall with the funds rate.)

The rate on 10-year Treasury notes also rises in CBO's forecast but to a lesser degree than the rate on short-term securities. To a certain extent, the near-term outlook for monetary policy affects day-to-day and month-to-month changes in rates on long-term financial instruments. The path of those rates, however, tends to be governed by the long-term outlook for inflation and the potential for real returns from capital investment. CBO thus forecasts that the rate on 10-year Treasury notes will average 4.8 percent and 5.4 percent in 2005 and 2006, respectively.

### Government Spending

The growth of real consumption and total investment spending by all levels of government slowed for a second year in 2004, rising by about 2 percent. Most of the slowdown in growth occurred in the spending of state and local governments; by contrast, real federal spending climbed by about 4¾ percent. That growth was buoyed by a strong increase in defense spending (over 7 percent) that reflected supplemental appropriations for activities in Iraq and Afghanistan and for other activities related to the war on terrorism. Real federal nondefense spending declined slightly in 2004. As in 2003, real spending by state and local governments grew by less than 1 percent.

CBO projects that during the next two years, the growth of real consumption plus investment in the government sector overall will continue to slow, despite a small rise anticipated in spending by states and localities. That slowdown stems from a projected weakening in defense spending, which largely results from the procedures that CBO is required to use to project defense and other discretionary spending (see Chapter 1).

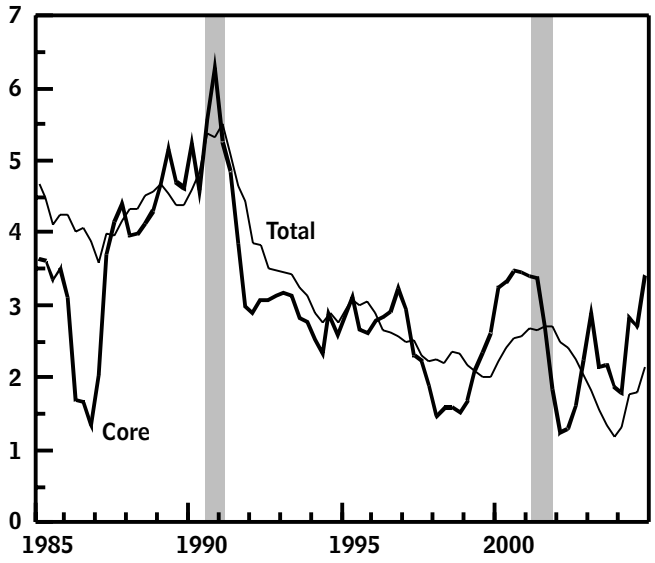
Most analysts expect that spending for Iraq and Afghanistan and for other activities related to the war on terrorism will be greater than the amount CBO has projected under the rules that govern its baseline projections. Consequently, CBO has developed an illustrative alternative for such spending (see Table 1-3 on page 8). The alternative incorporates the assumption that outlays are higher than in the current baseline by $30 billion in fiscal year 2005, $70 billion in 2006, and $75 billion in 2007; thereafter, outlays steadily decline. Additional outlays for the 2005-2015 period total $620 billion (including $172 billion in debt service).

If that spending path were incorporated in CBO's baseline, the forecast for real growth of GDP would be slightly faster in the near term but slightly slower, on average, over the 10-year projection horizon. Because roughly two-thirds of those outlays might be spent in the United States rather than abroad, the additional spending would boost economic growth slightly in the short term by adding to the demand for U.S. goods and services. For the next 10 years as a whole, however, the additional defense spending under that alternative path (plus the associated increase in interest payments) would produce larger federal deficits than those projected in the current baseline and would slightly reduce the growth of the economy's potential supply of output by crowding out some private investment. To a certain extent, increased private saving and more borrowing from abroad would offset the effect of those larger deficits. Nevertheless, investment during the 2005-2015 period would be lower than it would otherwise have been, and the resulting fall in national income would be greater, as payments to people in other countries increased to service the additional debt owed to them.

**Figure 2-9.**

## The Consumer Price Index: Total and Core Measures

(Percentage change from previous year)




Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: The core consumer price index is the consumer price index for all urban consumers excluding food and energy.

### Inflation

Special factors last year, such as the surge in oil prices and upturns in the cost of shelter and used cars, caused inflation as measured by the CPI-U to rise sharply, from 1.8 percent during 2003 to 3.4 percent during 2004 (see Figure 2-9). That increase, however, is not necessarily a harbinger of generally higher inflation. During the next two years, CBO forecasts, the growth in prices will be close to 2 percent. Some analysts believe that the long period of accommodative monetary policy, the solid economic growth of the past several quarters, and a falling dollar will drive inflation higher. Yet although CBO in its forecast acknowledges that there is some risk of inflation's being higher than it has assumed, it basically maintains that falling oil prices and an excess of productive capacity, both here and abroad, are likely to keep inflation low during the 2005-2006 period.

**Energy and Food Prices.** Prices for both energy and food grew rapidly during 2004, but CBO does not expect that price rises in either of those categories will exacerbate inflation in 2005 and 2006. An anticipated reversal in energy prices is the primary reason that CBO's forecast incorporates an assumption of lower inflation in 2005 than in 2004, a view strongly shared by many analysts. Indeed, CBO expects oil prices to be more than 10 percent lower in the fourth quarter of this year than they were in the fourth quarter of 2004 (see Box 2-2 on page 42). In addition, CBO expects a smaller rise during the next two years in the CPI-U for food and beverages—a category that accounts for 18 percent of the price index. Because of unusual weather and an upturn in beef prices (caused in part by a shift to the consumption of more protein), the food and beverages component of the CPI-U rose by 3.3 percent last year. CBO anticipates that during the forecast period, inflation in food prices will revert to its average of the past 15 years of about 2.5 percent.

**Core Inflation.** Hikes in energy and food prices were not the only reason for the spurt in growth of the price index in 2004. The core CPI-U—the CPI-U excluding the energy and food categories—grew by 2.2 percent over the course of the year, compared with a rise of 1.1 percent in 2003. Some analysts cite the 2004 increase as evidence of rapidly building inflationary pressures. However, only a small portion of the quickened pace of core inflation in 2004—the increase in import prices—implies a continuing upward push on prices during the next two years.

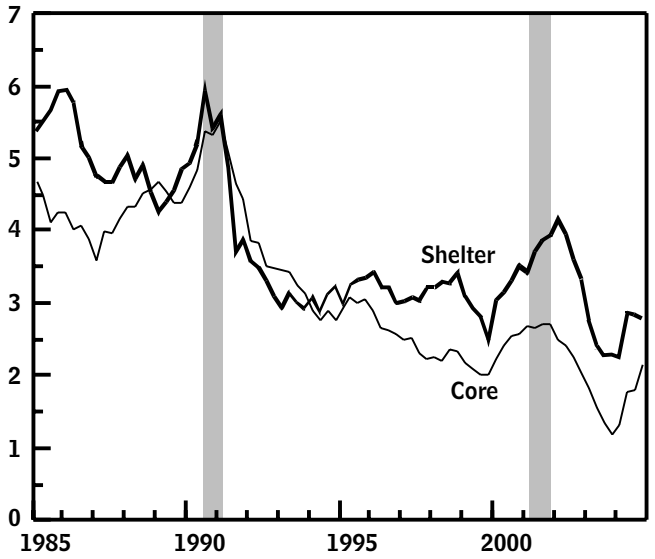
Bolstering CBO's belief that inflation will not surge in the near term is that most of the increase in the core rate in 2004 was simply a rebound from the unusually low rate of growth of prices in 2003. A little less than half of the acceleration in 2004 can be traced to the shelter price index in the CPI-U. That measure, which primarily comprises rental prices and has a total relative importance in the core CPI-U of about 42 percent, grew by 3.1 percent in 2002. During 2003, its rate of growth slumped, registering only 2.2 percent; then in 2004, it climbed again, to 2.7 percent (see Figure 2-10). A significant part of the acceleration in the core CPI-U during 2004, therefore, was caused by the rebound in the growth of prices for shelter. Although CBO forecasts that shelter prices will not accelerate further, that outlook is particularly uncertain, largely because the wide variation in the growth of the shelter price index over the past four years has not yet been satisfactorily explained.

Used car prices also contributed to the increase in inflation in 2004—but only because they were bouncing back from an unusually steep fall (12 percent) in 2003. Last year, the prices of used cars rose moderately, a reversal

**Figure 2-10.**

## The Consumer Price Index: Shelter and Core Measures

(Percentage change from previous year)




Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: The core consumer price index is the consumer price index for all urban consumers excluding food and energy.

that accounted for a significant part of the increase in core inflation. Nevertheless, that moderate amount of growth in such prices is more likely to prevail over the two-year forecast period than is another jump to higher inflation.

**Excess Capacity Versus the Risks of Higher Inflation.** The outlook for overall inflation during the next two years is favorable because excess productive capacity apparently exists both in the United States and abroad. Therefore, the long span of the Federal Reserve's accommodative monetary policy and the recent years of solid economic growth are not likely to push up inflation precipitately in the near term. In that environment, price shocks in the commodities markets (such as last year's surge in oil prices) may boost the overall price level, but they are unlikely to lead to sustained inflation. The drop in the dollar, together with the resulting hikes in the prices of imported goods and services, appears to be the single biggest risk for higher inflation.

At the end of 2004, the economy still had a considerable amount of excess capacity, largely because productivity growth had been so strong during the 2002-2004 period. CBO's estimate of potential GDP was about 1¼ percent higher than actual GDP at the end of 2004; annual growth of potential output in the near term is forecast to be about 3¼ percent. Thus, it appears that the economy could grow by about 4 percent annually for two years before some sectors would start to experience strains in their productive capacity. Indeed, in CBO's forecast, real GDP does not fully merge with potential GDP until the end of 2007.

Of course, the economy may have more or less excess capacity than CBO has forecast. Its current estimates, for example, indicate slightly more slack at the end of 2004 than was suggested in its update, in September 2004, of last January's *Budget and Economic Outlook*. However, those measures are subject to considerable uncertainty. Developing estimates of trends in the growth of productivity and labor force participation has been particularly difficult in recent years. Nevertheless, other indicators of capacity, such as measures of the manufacturing sector's capacity utilization, the percentage of the adult population who are employed, and the pace of core price inflation, support the view that the economy currently has a significant amount of slack.

The rise that is occurring in import prices as a result of the fall of the dollar is causing some inflationary pressure, but again, CBO expects that the excess supply in the economy will keep overall inflation mild throughout the two-year forecast period. The growth of import prices has mirrored the ups and downs in the value of the dollar. For example, during the 1995-2001 period, when the dollar was generally rising, the prices of imports fell. By contrast, since early 2002 and the beginning of the dollar's fall, import prices have been rising. CBO anticipates that the dollar will fall further, causing import prices to continue to rise for several years. However, in CBO's estimation, the growth of prices for imported non-oil goods is likely to be contained during 2005 and 2006 and should not result in higher inflation.

## The Economic Outlook Through 2015

CBO projects that real GDP will grow at an average annual rate of 2.9 percent during the 2007-2015 period, or slightly faster than potential GDP during the same span. Growth of real GDP, though fast during 2005 and 2006, is not expected to fully close the gap between real and

**Box 2-2.**

## Is the Price of Oil Going to Fall?

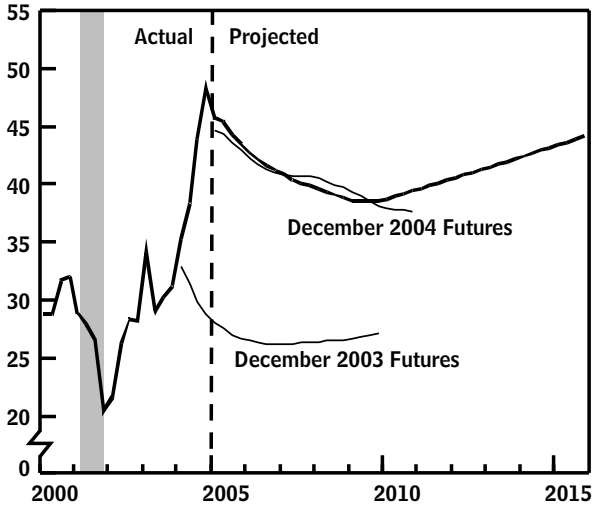
The price of high-quality oil in the U.S. spot market (the market dealing in oil for immediate delivery) stood at $43 per barrel in December 2004. At the same time, prices in the futures market for oil (for delivery in later months) were somewhat lower—about $40 for delivery in December 2006, for example (see the figure below). That disparity seems to suggest that the futures market expects the spot price of oil to fall. Partly on the basis of the downward-trending path suggested by prices in the New York Mercantile Exchange's (NYMEX's) oil-futures market, the Congressional Budget Office (CBO) has assumed for the purposes of its economic forecast that, through 2009, oil prices will fall from their current peak levels. Thereafter, prices are projected to rise through 2015 at the same rate as overall inflation.

Utilizing prices in the futures market raises questions about whether such indicators are a reliable guide to longer-term spot prices. Futures prices are often below spot prices—including, for instance, the period in early 2004 when spot prices were rising from less than $35 per barrel to more than $50. Yet users of futures-market forecasts know that such predictions, though unlikely to precisely delineate the path that spot prices will eventually follow, may nevertheless be among the best methods available to predict the future price of oil.

For example, the Bank of England's monetary policy committee, in its quarterly *Inflation Report* of November 2000, noted that it "has maintained the assumption that the futures market provides the best guide to the outlook for the oil price" (p. 50). The Federal Reserve Board has also used information on prices in futures markets to gauge inflationary pressures.[1] Participation in the oil futures market is quite extensive: in late 2004, for example, contracts for future delivery of oil amounted to more than 700 million barrels at NYMEX. (That figure rises to more than 1 billion barrels, if contracts at the London International Petroleum Exchange are included.) By comparison, world production of oil through most of 2004 averaged just over 72 million barrels per day, implying that current futures contracts cover almost 15 days of production.

**Price of Oil**

(Dollars per barrel)




Sources: Congressional Budget Office; New York Mercantile Exchange; *Wall Street Journal.*

1. For a recent example, see the remarks of Ben Bernanke, Governor of the Federal Reserve Board, on "Oil and the Economy," Distinguished Lecture Series, Darton College, Albany, Georgia, October 21, 2004, available at www.federalreserve.gov/boarddocs/speeches/2004/20041021/default.htm.

**Box 2-2.**

## Continued

Although projections based on futures-market prices are subject to large errors, they do not appear to have a significant bias. Oil prices in the futures market reflect the consensus of the market's participants about the evolution of future demand and supplies—but that consensus can certainly be wrong. For example, futures-market predictions of the price of oil for delivery in December 2004 ranged from as low as $16 per barrel (in March 1999) to as high as $56 (in late October 2004). Presumably, the variation in December delivery prices during that period reflected emerging changes in actual and predicted demand as well as supplies that had not previously been taken into account.

Forecasters might be concerned about a bias in the futures market if, for example, participants whose beliefs underlay the consensus futures price were more affected by the potential for losses than by the prospect of gains. Aversion to the risk of losses could distort the course of oil prices as projected by the market. Available research into such a distortion has not uncovered strong evidence of it. For example, calculations by Federal Reserve Board economists indicate that average forecasting errors from a comparison of 12-month futures prices with subsequent spot prices from April 1989 to December 2003 were insignificant.[2]

Several possible contributing factors have been suggested to explain why futures-market prices indicate a drop from current levels in the spot market. For example, currently tight market conditions may be creating temporary bottlenecks, which market participants expect will be gradually resolved. Recent indications of such constrictions include strong growth in world demand amid low levels of inventories; threatened or actual disruptions in supplies from some countries (such as Nigeria, Venezuela, and Russia); production by other major suppliers (such as Saudi Arabia) that may be near short-term capacity; and world oil transport systems that are also temporarily operating at almost their full potential. (A report in London's *Financial Times* of November 3, 2004, cited a "20-fold rise in tanker rates in the last two years.")

Another likely reason for the drop in oil prices indicated by the futures market is heightened uncertainty about longer-term market conditions and prices. With the possibility that prices might be substantially higher in the future, some producers may have been induced to curtail current production by the prospect of bigger profits down the road—a plan that, if followed, would push up spot prices. Such producers, of course, would also run the risk of encountering unusually low prices in the future and earning lower-than-expected profits, but they would have the option of limiting production then as well and waiting for more profitable conditions to emerge. The existence of that option implies that current prices may have to be higher than prices in futures markets to induce producers to sell now instead of later, and current prices may have to be higher still in the presence of heightened uncertainty about the future.[3]

2. See Sergey V. Chernenko, Krista B. Schwarz, and Jonathan H. Wright, *The Information Content of Forward and Futures Prices: Market Expectations and the Price of Risk*, International Finance Discussion Paper No. 808 (Board of Governors of the Federal Reserve System, June 2004).

3. The option effect on the relation between spot and futures prices is discussed in Robert Litzenberger and Nir Rabinowitz, "Backwardation in Oil Futures Markets: Theory and Empirical Evidence," *Journal of Finance*, vol. 50, no. 5 (December, 1995), pp. 1517-1545.

potential GDP by the end of 2006. As a result, real GDP is projected to grow nearly two-tenths of a percentage point faster than potential GDP in 2007 and 2008 but then to rise at the same rate thereafter. From 2007 through 2015, in CBO's view, CPI-U inflation will average 2.2 percent and the unemployment rate, 5.2 percent. The rate on three-month Treasury bills is estimated to average 4.6 percent over the medium term, and the rate on 10-year Treasury notes, 5.5 percent.

To develop its medium-term projections for 2007 through 2015, CBO projects levels and rates for the factors that underlie potential GDP, such as growth of the labor force, capital services (the productive services provided by the economy's capital stock), and productivity. In so doing, CBO takes into account the effect that current fiscal policy may have on those variables, but it does not attempt to forecast business-cycle fluctuations beyond the next two years.

## Potential Output

CBO's projection of potential output during the 2005-2015 period shows output growing at an average annual rate of 2.9 percent, or about six-tenths of a percentage point slower than its long-run average pace of 3.5 percent (see Table 2-2). That slower projected growth is almost entirely due to a dramatic slowdown expected in the rate of expansion of the potential labor force, as the large cohort of workers born during the postwar baby boom begins to reach the traditional age for retirement. By contrast, capital accumulation and productivity growth are projected to grow at rates that approximate their long-run averages. Although in CBO's estimation, potential GDP will grow more slowly than its historical average, its estimated rate of growth will still be about a tenth of a percentage point faster than the rate CBO projected in September 2004. CBO's new, higher projection stems from its expectation of slightly faster growth of total factor productivity and from an upward revision in its projection of the growth of capital services.

**The Potential Labor Force.** CBO's projection of growth in the potential labor force between 2005 and 2015 (0.8 percent, on average—the same rate that CBO forecast last September) is slower than its historical rate of growth of 1.6 percent during the 1950-2003 period. The slower projected pace stems from CBO's expectation that labor force participation will decline sharply during the next 10 years. That decline occurs largely because the leading edge of the baby-boom generation reaches the traditional retirement age, but it is also spurred by other factors: the rate of men's labor force participation is likely to continue its historical downward trend; women are not expected to increase their rate of participation as much as they did in the past; and the tax cuts in the Economic Growth and Tax Relief Reconciliation Act of 2001 and JGTRRA are scheduled to expire in 2011, which will raise the marginal tax rate on labor (the rate on the last dollar of income) and lessen the incentive to work. The slowdown in the growth of the potential labor force is reflected in CBO's estimate of potential hours worked—that factor is projected to grow at an annual average rate of 0.9 percent during the period (a growth rate similar to that reported last September in CBO's update of its January 2004 outlook).

**Capital Services.** Capital services during the 2005-2015 period are now expected to grow by 4.2 percent per year, on average, or about 0.5 percentage points faster than CBO envisioned last September. That revision did not result from a new projection for investment spending—the share of potential GDP that such spending makes up is about the same in CBO's current outlook (12 percent, on average) as it was in last September's. Instead, the revised outlook for capital accumulation results from the combination of revisions to data on the capital stock by the Bureau of Economic Analysis (including data for 2003) and a revised weighting scheme for different types of capital. Those changes led to estimates of a faster pace of growth in capital services during recent years and in the 10-year projection period.

**Total Factor and Labor Productivity.** Over the next 10 years, total factor productivity is likely to rise at an average annual rate of 1.4 percent, in CBO's estimation—which is roughly equal to the average rate of growth of potential TFP during the 1950-2004 period and almost identical to the rate that CBO projected last September. Since September, however, CBO has changed its method for calculating and projecting potential TFP in response to changes in the data underlying that estimate (see Box 2-1 on page 29). A series of revisions in recent years has reduced the estimated rate of growth of TFP during the 1990-1999 period. As a result, a special adjustment to the TFP estimate—associated with improvements in computer quality—is no longer necessary, and CBO has discontinued it.[10] That change raised the growth of poten-

10. CBO provides more information about its method on its Web site (www.cbo.gov); see "CBO's Revised Method for Estimating and Projecting Potential TFP."

**Table 2-2.**

## Key Assumptions in CBO's Projection of Potential Output

(By calendar year, in percent)

| | Average Annual Growth | | | | | | Projected Average Annual Growth | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1950-1973 | 1974-1981 | 1982-1990 | 1991-1995 | 1996-2004 | Total, 1950-2004 | 2005-2010 | 2011-2015 | Total, 2005-2015 |
| **Overall Economy** | | | | | | | | | |
| Potential Output | 3.9 | 3.3 | 3.0 | 2.7 | 3.4 | 3.5 | 3.2 | 2.7 | 2.9 |
| Potential Labor Force | 1.6 | 2.5 | 1.6 | 1.2 | 1.2 | 1.6 | 1.1 | 0.6 | 0.8 |
| Potential Labor Force Productivity[a] | 2.3 | 0.8 | 1.4 | 1.5 | 2.2 | 1.8 | 2.1 | 2.1 | 2.1 |
| **Nonfarm Business Sector** | | | | | | | | | |
| Potential Output | 4.0 | 3.6 | 3.1 | 3.1 | 3.9 | 3.7 | 3.5 | 3.0 | 3.3 |
| Potential Hours Worked | 1.4 | 2.4 | 1.4 | 1.4 | 1.4 | 1.5 | 1.2 | 0.6 | 0.9 |
| Capital Input | 3.8 | 4.2 | 3.9 | 2.7 | 4.6 | 3.9 | 4.5 | 3.7 | 4.2 |
| Potential Total Factor Productivity | 1.9 | 0.7 | 0.9 | 1.3 | 1.6 | 1.4 | 1.4 | 1.4 | 1.4 |
| Potential TFP excluding adjustments | 1.9 | 0.7 | 1.0 | 1.3 | 1.3 | 1.4 | 1.3 | 1.3 | 1.3 |
| TFP adjustments | 0 | 0 | 0 | * | 0.3 | * | 0.1 | 0.1 | 0.1 |
| Price measurement[b] | 0 | 0 | 0 | * | 0.1 | * | 0.1 | 0.1 | 0.1 |
| Temporary adjustment[c] | 0 | 0 | 0 | 0 | 0.2 | * | 0 | 0 | 0 |
| Contributions to Growth of Potential Output (Percentage points) | | | | | | | | | |
| Potential hours worked | 1.0 | 1.7 | 1.0 | 1.0 | 0.9 | 1.1 | 0.8 | 0.4 | 0.6 |
| Capital input | 1.1 | 1.3 | 1.2 | 0.8 | 1.4 | 1.2 | 1.4 | 1.1 | 1.2 |
| Potential TFP | 1.9 | 0.7 | 0.9 | 1.3 | 1.6 | 1.4 | 1.4 | 1.4 | 1.4 |
| Total Contributions | 4.0 | 3.7 | 3.1 | 3.0 | 3.9 | 3.7 | 3.6 | 2.9 | 3.3 |
| **Memorandum:** | | | | | | | | | |
| Potential Labor Productivity[d] | 2.6 | 1.2 | 1.7 | 1.7 | 2.5 | 2.2 | 2.4 | 2.3 | 2.4 |

Source: Congressional Budget Office.

Note: * = between zero and 0.05.

a. The ratio of potential GDP to the potential labor force.

b. An adjustment for a conceptual change in the official measure of the GDP price index.

c. An adjustment for the unusually rapid growth between 2001 and 2003.

d. The estimated trend in the ratio of output to hours worked in the nonfarm business sector.

tial TFP very slightly (by a few hundredths of a percentage point) during the period since 1990.

### Inflation, Unemployment, and Interest Rates

Between 2006 and 2015, inflation as measured by the CPI-U is expected to average 2.2 percent, and the GDP price index is projected to grow at an average annual rate of 1.8 percent. Both rates are identical to those projected in September 2004. In general, CBO assumes that the Federal Reserve's monetary policy will result in an underlying rate of CPI-U inflation that averages between 2 percent and 2.5 percent.[11] The unemployment rate during the period, in CBO's view, will average 5.2 percent—

11. The Federal Reserve's preferred measure of core inflation is the price index for personal consumption expenditures (PCE) excluding food and energy prices. Growth of the core PCE price index over the 10-year projection period is likely to be about a quarter of a percentage point slower, on average, than the growth of the core CPI-U.

which is identical to CBO's estimate of the nonaccelerating inflation rate of unemployment, or NAIRU.[12]

CBO's medium-term projections of interest rates (which it estimates by adding its projection for inflation to its projection for real interest rates) have not altered since last September. Using the CPI-U as a measure of price changes, CBO estimates that the real rate on three-month Treasury bills will average 2.4 percent during the 2007-2015 period and that the real rate on 10-year Treasury notes will average 3.3 percent. Combined with the projected rates of CPI-U inflation, those real rates imply nominal rates over the medium term of 4.6 percent for three-month Treasury bills and 5.5 percent for 10-year Treasury notes.

## Taxable Income

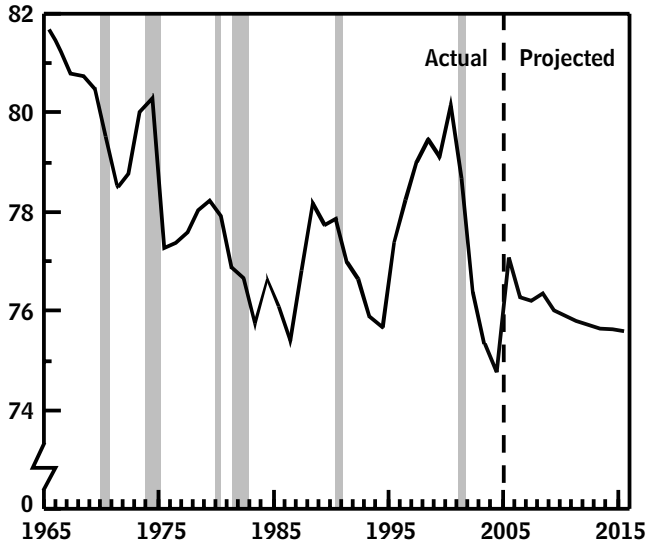
Forecasts of the growth of specific categories of income (such as wages and salaries, corporate profits, and proprietors' income) drive projections of revenues.[13] In CBO's two-year forecast, the share of GDP reflecting income categories that affect revenue projections bounces up in 2005, falls back in 2006, and drifts downward thereafter (see Figure 2-11). The rise in 2005 stems largely from the expiration of tax provisions that have allowed firms to deduct from their profits a larger-than-usual percentage of their expenditures on equipment and structures. Once those provisions expire, profits subject to tax are expected to rise in 2005 relative to 2004.

The drop in the share of taxable income that CBO projects for 2006 stems from its expectation that, under current law, firms will have to make larger-than-usual contributions to defined-benefit pension plans that year (see Appendix D). Those contributions are not considered part of a firm's taxable income; as a result, the profits share of GDP is likely to be smaller than it would otherwise be. The reduction in profits accounts for the bulk of the drop in the taxable income share forecast for 2006.

**Figure 2-11.**

**Total Share of GDP for Income Categories That Affect Revenue Projections**

(Percentage of GDP)




Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Income categories include the following, measured on a national income and product accounts basis: wages and salaries, book profits, proprietors' income, rental income, personal dividend income, and personal interest income.

Broadly speaking, GDP can be divided into a share that goes to labor and a share that goes to capital. Labor's share is the sum of the following categories: wages and salaries; payments made by employers on behalf of workers (such as the employer's share of health insurance premiums and contributions to pension funds, as well as payments for Social Security and Medicare); and about 70 percent of the income of proprietors.[14] The rest of GDP is capital's share. Although the shares of labor and capital have varied over the postwar period, labor's share has averaged 62.7 percent of GDP and capital's, 37.3 percent.

Wages and salaries, the category of income that is most important for revenue projections, is forecast to rise from an estimated 45.6 percent of GDP in 2004 to 45.8 per-

12. The NAIRU is the unemployment rate consistent with a constant rate of inflation. An unemployment rate higher than the NAIRU indicates downward pressure on inflation, whereas an unemployment rate lower than the NAIRU indicates upward pressure on inflation. Estimates of the NAIRU are based on the historical relationship between inflation and the unemployment rate.

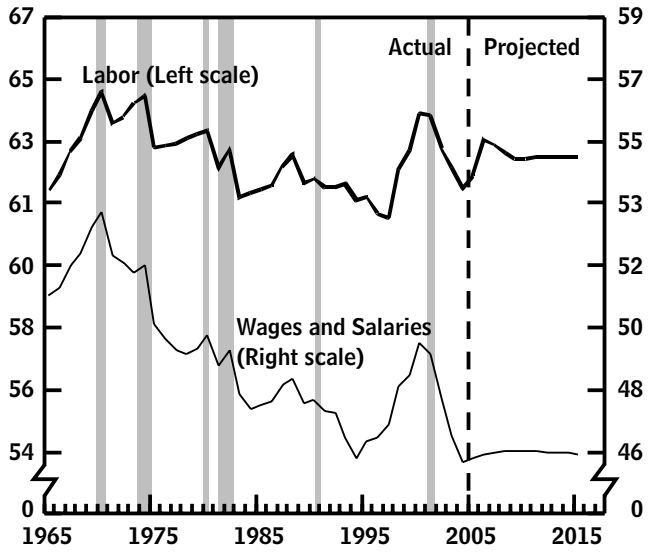
13. Proprietors' income is the income of self-employed workers.

14. Exactly how much of the income earned by proprietors is a return to capital (the equipment and structures that self-employed workers use) and how much is a return to labor is unclear. However, 70 percent of total proprietors' income is generally assumed to be the return to labor.

**Figure 2-12.**

## Labor Income and Wages and Salaries

(Percentage of GDP)




Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

cent in 2006; it is then expected to average 45.9 percent during the remainder of the 10-year projection period. Since the mid-1960s, that share has shrunk (see Figure 2-12); however, labor's overall share of output has not declined, and CBO projects that it will remain high for a few years, bolstered by firms' higher-than-usual contributions to their defined-benefit plans. Later, CBO expects, labor's share of GDP will remain close to its postwar average of 62.7 percent.[15]

The difference since 1980 between the trends in labor's share of total income and in the share of wages and salaries has arisen primarily because of the increase in the shares of GDP claimed by health benefits, pensions, and proprietors' income. CBO estimates that over the next 10 years, the share of income claimed by proprietors will level off, the share attributable to health benefits will steadily increase, and the portion of income that represents pension payments will initially rise sharply and then fall. On balance, the overall share of GDP that those categories constitute does not increase over the 10-year period, so the share of labor's income that is attributable to wages and salaries does not trend downward.

Uncertainty about the path of the shares of income that affect revenue projections has been a source of error in CBO's budget projections in the past and is a major risk to the accuracy of the current forecast. Even though CBO's annual estimates of nominal GDP during the late 1990s were quite accurate, CBO consistently understated the increase in revenues occurring during that period because it failed to anticipate growth in some of the categories of income—in particular, an extraordinary increase in the share of wages and salaries—that are important in estimating revenues. (The wages and salaries share jumped in part because of stock options that were exercised during the late-1990s boom in the stock market.) Conversely, CBO underestimated the speed of the drop in that share during the early 2000s, which led to budget projections that were too optimistic. The variability in income shares during the 1995-2002 period was extremely unusual, but it is certainly possible that such shares will be significantly greater or smaller over the next 10 years than CBO is currently projecting.

## Changes in CBO's Outlook Since September 2004

CBO's current view of the economy is broadly similar to its outlook in September 2004, though with some notable differences (see Table 2-3). The growth of real GDP in CBO's current estimates is slightly slower for 2004 and 2005, reflecting, in part, slightly higher prices for oil and lower assumed government spending for defense. For 2006 and thereafter, the growth of real GDP is faster, reflecting a brighter outlook for growth of potential GDP in the medium term than CBO had projected in September. Revisions to the outlook for the unemployment rate mirror those to the forecast of GDP growth: for 2006, the rate is slightly higher than last September's but then, for the medium term, falls back to 5.2 percent—CBO's estimate of the NAIRU.

In CBO's current estimates, inflation as measured by the CPI-U grows at about the same rate in 2005 and 2006 as it did in CBO's September forecast. The year-over-year growth rate for 2005 of 2.4 percent, as reported in Table 2-3, contains some residual effect of the spike in energy prices that actually occurred in 2004. For 2005, the CPI-U is forecast to grow by 1.9 percent (measured on a fourth-quarter-over-fourth-quarter basis); for the

15. CBO assumes that most of those contributions come from profits and not from any form of labor compensation.

## Table 2-3.

# CBO's Current and Previous Economic Projections for Calendar Years 2004 to 2014

| | Estimated | Forecast | | Projected Annual Average | |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007 to 2010[a] | 2011 to 2014[b] |
| Nominal GDP (Billions of dollars) | | | | | |
| January 2005 | 11,730 | 12,396 | 13,059 | 15,940 | 19,031 |
| September 2004 | 11,753 | 12,464 | 13,058 | 15,697 | 18,628 |
| Nominal GDP (Percentage change) | | | | | |
| January 2005 | 6.6 | 5.7 | 5.3 | 5.1 | 4.5 |
| September 2004 | 6.8 | 6.1 | 4.8 | 4.7 | 4.4 |
| Real GDP (Percentage change) | | | | | |
| January 2005 | 4.4 | 3.8 | 3.7 | 3.3 | 2.7 |
| September 2004 | 4.5 | 4.1 | 3.2 | 2.9 | 2.6 |
| GDP Price Index (Percentage change) | | | | | |
| January 2005 | 2.1 | 1.8 | 1.5 | 1.8 | 1.8 |
| September 2004 | 2.2 | 1.8 | 1.5 | 1.7 | 1.8 |
| Consumer Price Index[c] (Percentage change) | | | | | |
| January 2005 | 2.7 | 2.4 | 1.9 | 2.2 | 2.2 |
| September 2004 | 2.6 | 2.0 | 2.0 | 2.2 | 2.2 |
| Unemployment Rate (Percent) | | | | | |
| January 2005 | 5.5 | 5.2 | 5.2 | 5.2 | 5.2 |
| September 2004 | 5.6 | 5.2 | 5.1 | 5.2 | 5.2 |
| Three-Month Treasury Bill Rate (Percent) | | | | | |
| January 2005 | 1.4 | 2.8 | 4.0 | 4.6 | 4.6 |
| September 2004 | 1.3 | 2.6 | 4.0 | 4.6 | 4.6 |
| Ten-Year Treasury Note Rate (Percent) | | | | | |
| January 2005 | 4.3 | 4.8 | 5.4 | 5.5 | 5.5 |
| September 2004 | 4.6 | 5.4 | 5.5 | 5.5 | 5.5 |
| Tax Bases (Billions of dollars) | | | | | |
| Corporate book profits | | | | | |
| January 2005 | 984 | 1,331 | 1,222 | 1,349 | 1,566 |
| September 2004 | 1,045 | 1,455 | 1,430 | 1,447 | 1,710 |
| Wages and salaries | | | | | |
| January 2005 | 5,346 | 5,665 | 5,979 | 7,317 | 8,721 |
| September 2004 | 5,370 | 5,703 | 6,003 | 7,238 | 8,592 |
| Tax Bases (Percentage of GDP) | | | | | |
| Corporate book profits | | | | | |
| January 2005 | 8.4 | 10.7 | 9.4 | 8.7 | 8.3 |
| September 2004 | 8.9 | 11.7 | 11.0 | 9.6 | 9.1 |
| Wages and salaries | | | | | |
| January 2005 | 45.6 | 45.7 | 45.8 | 45.9 | 45.9 |
| September 2004 | 45.7 | 45.8 | 46.0 | 46.1 | 46.1 |
| **Memorandum:** | | | | | |
| Real Potential GDP (Percentage change) | | | | | |
| January 2005 | 3.2 | 3.2 | 3.3 | 3.1 | 2.7 |
| September 2004 | 3.1 | 3.1 | 3.2 | 2.9 | 2.6 |

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

a. For projections in billions of dollars, the level is that in 2010.

b. For projections in billions of dollars, the level is that in 2014.

c. The consumer price index for all urban consumers.

medium term, growth is expected to average 2.2 percent, the same rate that CBO projected last September. Changes to CBO's view of the GDP price index since last fall are modest, with slightly faster growth anticipated in the near term and little change in the medium term. CBO's outlook for short-term and long-term interest rates in the medium term has remained virtually unchanged since September. However, CBO now anticipates that for 2005 and 2006, short-term interest rates will be slightly higher than it envisioned in September, and long-term rates will be lower.

## A Comparison of Forecasts

Comparing the estimates of CBO, the Administration, and a consensus of private-sector forecasters reveals some differences, but in general, the three outlooks are similar (see Table 2-4). CBO's forecast for inflation during the next two years is lower, and its estimate of real GDP growth slightly higher, than those of the Administration and the *Blue Chip* consensus forecast. (The *Blue Chip* forecast is an average of the estimates of about 50 private-sector forecasters.) Otherwise, CBO's outlook for the two-year horizon is similar to both the *Blue Chip*'s and the Administration's. CBO's estimates of the unemployment rate, nominal GDP growth, and interest rates differ little from those of the other forecasts, reflecting the widespread view that growth over the next two years will be higher than its historical trend rate, interest rates will rise slightly, and the unemployment rate will ease slowly downward.

CBO's forecast for real GDP growth over the longer term is the same as that of the Administration. For the 2007-2010 period (the Administration's forecast does not extend beyond 2010), both agencies foresee real GDP growth averaging 3.2 percent, and there is little difference between their estimates of the unemployment rate and the long-term interest rate. CBO envisions lower inflation, however—notably for the GDP price index—and higher short-term interest rates. Therefore, real short-term interest rates are significantly higher in CBO's forecast than in the Administration's.

**Table 2-4.**

# Comparison of CBO, *Blue Chip*, and Administration Forecasts for 2004 to 2010

| | Estimated 2004 | Forecast 2005 | Forecast 2006 | Projected Annual Average, 2007 to 2010 |
|---|---|---|---|---|
| | Fourth Quarter to Fourth Quarter (Percentage Change) | | | |
| Nominal GDP | | | | |
| *Blue Chip* consensus | 6.3 | 5.5 | 5.3 | n.a. |
| CBO | 6.3 | 5.5 | 5.4 | 5.0 |
| Administration | 6.3 | 5.5 | 5.6 | 5.3 |
| Real GDP | | | | |
| *Blue Chip* consensus | 3.9 | 3.5 | 3.3 | n.a. |
| CBO | 3.9 | 3.7 | 3.8 | 3.2 |
| Administration | 3.9 | 3.5 | 3.4 | 3.2 |
| GDP Price Index | | | | |
| *Blue Chip* consensus | 2.4 | 1.9 | 2.0 | n.a. |
| CBO | 2.2 | 1.7 | 1.5 | 1.8 |
| Administration | 2.3 | 1.9 | 2.0 | 2.1 |
| Consumer Price Index[a] | | | | |
| *Blue Chip* consensus | 3.4 | 2.3 | 2.4 | n.a. |
| CBO | 3.4 | 1.9 | 2.0 | 2.2 |
| Administration | 3.4 | 2.0 | 2.3 | 2.4 |
| | Calendar Year Average | | | |
| Unemployment Rate (Percent) | | | | |
| *Blue Chip* consensus | 5.5 | 5.3 | 5.2 | n.a. |
| CBO | 5.5 | 5.2 | 5.2 | 5.2 |
| Administration | 5.5 | 5.4 | 5.2 | 5.1 |
| Three-Month Treasury Bill Rate (Percent) | | | | |
| *Blue Chip* consensus | 1.4 | 3.0 | 3.8 | n.a. |
| CBO | 1.4 | 2.8 | 4.0 | 4.6 |
| Administration | 1.4 | 2.7 | 3.5 | 4.1 |
| Ten-Year Treasury Note Rate (Percent) | | | | |
| *Blue Chip* consensus | 4.3 | 4.7 | 5.3 | n.a. |
| CBO | 4.3 | 4.8 | 5.4 | 5.5 |
| Administration | 4.3 | 4.6 | 5.2 | 5.5 |

Source: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Aspen Publishers, Inc., Blue Chip Economic Indicators (January 10, 2005); Council of Economic Advisers, Department of the Treasury, and Office of Management and Budget, "Administration Economic Forecast" (joint press release, December 17, 2004).

a. The consumer price index for all urban consumers.

CHAPTER

# 3

# The Spending Outlook

The Congressional Budget Office estimates that if current laws governing mandatory programs remain the same and discretionary appropriations total $840 billion, the amount provided thus far for 2005, outlays this year will rise by $133 billion to $2.4 trillion—a 5.8 percent increase over their level in 2004 (see Tables 3-1 and 3-2). However, no funding has yet been provided this year for activities in Iraq and Afghanistan. Such funding—when provided—is likely to add about $30 billion to outlays this year, raising growth in total outlays in 2005 to 7.1 percent, higher than the 6.1 percent growth experienced from 2003 to 2004.

Total spending as a percentage of gross domestic product dropped slightly between 2003 and 2004, from 19.9 percent to 19.8 percent. Under baseline projections, CBO estimates that outlays will remain at that level of GDP in 2005; once additional funding is provided for operations in Iraq and Afghanistan, that figure is likely to rise to at least 20.1 percent.

Fueling the growth in outlays projected for 2005 is continued expansion of both mandatory and discretionary spending (a significant portion of which stems from budget authority granted before 2005). In addition, CBO estimates that net interest payments will increase by 10.8 percent in 2005, the result of rising interest rates and accumulating federal debt. Outlays for mandatory programs—which account for more than half of all federal spending—are expected to grow by $80 billion (6.5 percent) over their level in 2004. In the absence of further appropriations, outlays for discretionary defense activities are projected to climb by $10 billion, or 2.2 percent, in 2005. Once operations in Iraq and Afghanistan are fully funded, that rate of increase will most likely grow to about 8.9 percent. For nondefense discretionary programs, outlays are expected to increase by $25 billion (5.8 percent). (See Box 3-1 on page 54 for descriptions of the various types of federal spending.)

The mix of federal spending has changed significantly over the past several decades. Today the government spends less—as a percentage of GDP—on discretionary activities and more on mandatory programs. Discretionary spending declined from 12.7 percent of GDP in 1962 to 6.3 percent in 1999 and 2000 before rebounding to 7.7 percent in 2004 (see Figure 3-1 on page 55). By contrast, mandatory spending—net of offsetting receipts—has climbed from 4.9 percent of GDP to 10.7 percent over the same period. Net interest has remained between 1.2 percent and 3.3 percent of GDP since 1962. In 2005, the share of the economy represented by each of the three major spending categories is expected to remain close to the share recorded in 2004. (For detailed annual data on spending since 1962, see Appendix F.)

Outlays in CBO's baseline are projected to grow at an average annual rate of 4.3 percent over the next 10 years—declining to 18.7 percent of GDP in 2012, before climbing to 18.9 percent of GDP in 2015 as mandatory spending accelerates. If current policies remain unchanged, mandatory outlays, led by growth in Medicare and Medicaid, will grow by about 5.7 percent. At that rate, those outlays will claim 11.7 percent of GDP by 2015—a percentage point above their share in 2004. CBO projects that interest payments as a share of GDP will increase to 1.9 percent by 2008 as a result of continuing deficits and the rising interest rates discussed in CBO's economic forecast (see Chapter 2 for details of CBO's economic outlook). That percentage will fall slightly toward the end of the 10-year projection period, to 1.5 percent of GDP, as the baseline assumptions of restrained growth in discretionary outlays and the scheduled rise in taxes under current law lead to diminished borrowing needs.

After 2005, under assumptions required by law for the baseline, discretionary outlays are projected to grow at an average annual rate of 1.7 percent and to gradually de-

## Table 3-1.

# CBO's Projections of Spending Under Baseline Assumptions

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | In Billions of Dollars | | | | | | | |
| Outlays | | | | | | | | | | | | | | |
| Discretionary spending | | | | | | | | | | | | | | |
| Defense | 454 | 464 | 438 | 435 | 447 | 457 | 468 | 484 | 488 | 504 | 516 | 529 | 2,245 | 4,765 |
| Nondefense | 441 | 466 | 476 | 485 | 493 | 502 | 511 | 523 | 534 | 546 | 559 | 572 | 2,468 | 5,202 |
| Subtotal | 895 | 930 | 914 | 919 | 940 | 959 | 980 | 1,006 | 1,022 | 1,050 | 1,075 | 1,101 | 4,713 | 9,966 |
| Mandatory spending | | | | | | | | | | | | | | |
| Social Security | 492 | 517 | 540 | 564 | 592 | 623 | 659 | 697 | 739 | 785 | 835 | 888 | 2,978 | 6,922 |
| Medicare | 297 | 325 | 380 | 426 | 453 | 484 | 520 | 565 | 598 | 654 | 708 | 766 | 2,263 | 5,554 |
| Medicaid | 176 | 186 | 193 | 205 | 223 | 241 | 262 | 284 | 307 | 333 | 361 | 392 | 1,124 | 2,802 |
| Other spending | 381 | 412 | 408 | 413 | 428 | 440 | 451 | 470 | 454 | 473 | 487 | 500 | 2,140 | 4,523 |
| Offsetting receipts | -109 | -122 | -140 | -159 | -167 | -168 | -179 | -191 | -203 | -217 | -231 | -244 | -813 | -1,899 |
| Subtotal | 1,237 | 1,317 | 1,380 | 1,450 | 1,529 | 1,620 | 1,713 | 1,824 | 1,896 | 2,028 | 2,159 | 2,303 | 7,692 | 17,902 |
| Net interest | 160 | 178 | 213 | 249 | 274 | 289 | 303 | 311 | 314 | 311 | 308 | 303 | 1,328 | 2,875 |
| **Total** | **2,292** | **2,425** | **2,507** | **2,618** | **2,743** | **2,869** | **2,996** | **3,142** | **3,232** | **3,389** | **3,542** | **3,706** | **13,733** | **30,743** |
| On-budget | 1,913 | 2,024 | 2,092 | 2,190 | 2,300 | 2,409 | 2,517 | 2,644 | 2,711 | 2,841 | 2,965 | 3,097 | 11,508 | 25,766 |
| Off-budget | 380 | 401 | 415 | 428 | 443 | 460 | 479 | 497 | 521 | 548 | 577 | 609 | 2,225 | 4,977 |
| | | | | | | | As a Percentage of GDP | | | | | | | |
| Outlays | | | | | | | | | | | | | | |
| Discretionary spending | | | | | | | | | | | | | | |
| Defense | 3.9 | 3.8 | 3.4 | 3.2 | 3.1 | 3.0 | 3.0 | 2.9 | 2.8 | 2.8 | 2.7 | 2.7 | 3.1 | 2.9 |
| Nondefense | 3.8 | 3.8 | 3.7 | 3.6 | 3.4 | 3.3 | 3.2 | 3.2 | 3.1 | 3.0 | 3.0 | 2.9 | 3.4 | 3.2 |
| Subtotal | 7.7 | 7.6 | 7.1 | 6.8 | 6.6 | 6.4 | 6.2 | 6.1 | 5.9 | 5.8 | 5.7 | 5.6 | 6.6 | 6.2 |
| Mandatory spending | | | | | | | | | | | | | | |
| Social Security | 4.3 | 4.2 | 4.2 | 4.2 | 4.1 | 4.1 | 4.2 | 4.2 | 4.3 | 4.4 | 4.4 | 4.5 | 4.2 | 4.3 |
| Medicare | 2.6 | 2.7 | 2.9 | 3.1 | 3.2 | 3.2 | 3.3 | 3.4 | 3.5 | 3.6 | 3.8 | 3.9 | 3.2 | 3.4 |
| Medicaid | 1.5 | 1.5 | 1.5 | 1.5 | 1.6 | 1.6 | 1.7 | 1.7 | 1.8 | 1.8 | 1.9 | 2.0 | 1.6 | 1.7 |
| Other spending | 3.3 | 3.4 | 3.2 | 3.0 | 3.0 | 2.9 | 2.9 | 2.8 | 2.6 | 2.6 | 2.6 | 2.5 | 3.0 | 2.8 |
| Offsetting receipts | -0.9 | -1.0 | -1.1 | -1.2 | -1.2 | -1.1 | -1.1 | -1.2 | -1.2 | -1.2 | -1.2 | -1.2 | -1.1 | -1.2 |
| Subtotal | 10.7 | 10.8 | 10.7 | 10.7 | 10.7 | 10.8 | 10.9 | 11.1 | 11.0 | 11.3 | 11.5 | 11.7 | 10.7 | 11.1 |
| Net interest | 1.4 | 1.5 | 1.7 | 1.8 | 1.9 | 1.9 | 1.9 | 1.9 | 1.8 | 1.7 | 1.6 | 1.5 | 1.9 | 1.8 |
| **Total** | **19.8** | **19.8** | **19.5** | **19.3** | **19.2** | **19.1** | **19.0** | **19.0** | **18.7** | **18.8** | **18.8** | **18.9** | **19.2** | **19.0** |
| On-budget | 16.6 | 16.5 | 16.2 | 16.1 | 16.1 | 16.0 | 16.0 | 16.0 | 15.7 | 15.8 | 15.8 | 15.8 | 16.1 | 15.9 |
| Off-budget | 3.3 | 3.3 | 3.2 | 3.2 | 3.1 | 3.1 | 3.0 | 3.0 | 3.0 | 3.0 | 3.1 | 3.1 | 3.1 | 3.1 |
| **Memorandum:** | | | | | | | | | | | | | | |
| Gross Domestic Product (Billions of dollars) | 11,553 | 12,233 | 12,888 | 13,586 | 14,307 | 15,029 | 15,757 | 16,494 | 17,245 | 18,023 | 18,826 | 19,652 | 71,566 | 161,806 |

Source: Congressional Budget Office.

**Table 3-2.**

## Average Annual Rates of Growth in Outlays Under CBO's Baseline

(Percent)

| | Actual 1993-2003 | Actual 2003-2004 | Estimated[a] 2004-2005 | Projected[b] 2005-2015 |
|---|---|---|---|---|
| Discretionary | 4.3 | 8.4 | 4.0 | 1.7 |
| Defense | 3.3 | 12.1 | 2.2 | 1.3 |
| Nondefense | 5.5 | 4.9 | 5.8 | 2.1 |
| Mandatory | 5.8 | 4.7 | 6.5 | 5.7 |
| Social Security | 4.5 | 4.5 | 5.1 | 5.6 |
| Medicare | 6.7 | 8.5 | 9.3 | 9.0 |
| Medicaid | 7.8 | 9.7 | 5.3 | 7.8 |
| Other[c] | 6.3 | -1.6 | 6.7 | -1.2 |
| Net Interest | -2.6 | 4.7 | 10.8 | 5.5 |
| Total Outlays | 4.4 | 6.1 | 5.8 | 4.3 |
| Total Outlays Excluding Net Interest | 5.2 | 6.2 | 5.4 | 4.2 |
| **Memorandum:** | | | | |
| Consumer Price Index | 2.5 | 2.3 | 2.8 | 2.2 |
| Nominal GDP | 5.1 | 6.6 | 5.9 | 4.9 |
| Discretionary Budget Authority | 5.3 | 6.7 | -7.3 | 2.4 |
| Defense | 5.1 | 6.7 | -13.3 | 2.4 |
| Nondefense | 5.4 | 6.6 | -0.3 | 2.3 |

Source: Congressional Budget Office.

a. CBO's baseline does not include estimates of future funding for operations in Iraq, Afghanistan, and the global war on terrorism (which have previously been funded through supplemental appropriations). As a result, budget authority provided thus far in 2005 for both defense and nondefense discretionary programs is lower than the amount provided in 2004. Excluding all supplemental appropriations (including those for disaster relief) in both years, total budget authority has grown by 5.1 percent in 2005 (6.6 percent for defense programs and 3.5 percent for nondefense programs).

b. As specified by the Deficit Control Act, CBO's baseline uses the employment cost index for wages and salaries to inflate discretionary spending related to federal personnel and the GDP deflator to adjust other discretionary funding.

c. Includes offsetting receipts.

cline as a share of GDP. That rate of growth is relatively low because 2005 outlays include some spending for operations in Iraq and Afghanistan that resulted from previous years' appropriations, but the years toward the end of the projection period do not include any such spending. Discretionary spending's share of the economy is projected to fall to 5.6 percent of GDP in 2015—about 2 percentage points below the current level.

## Mandatory Spending

Mandatory spending—also known as direct spending—has continued to grow as a share of federal outlays. Currently, such spending (net of offsetting receipts) stands at just over half of all federal spending. Most of the spending in this category involves payments to individuals and other entities, such as businesses, nonprofit institutions, and state and local governments. In general, those payments are governed by criteria set in law and are not normally constrained by the annual appropriation process. Offsetting receipts (certain payments that federal agencies receive from other governmental agencies or from the public) are classified as offsets to mandatory spending.

By 2015, direct spending is projected to constitute more than twice the share of federal outlays that it represented

**Box 3-1.**

## Categories of Federal Spending

On the basis of its treatment in the budget process, federal spending can be divided into three broad categories:

**Mandatory spending** consists primarily of benefit programs such as Social Security, Medicare, and Medicaid. The Congress generally determines spending for those programs by setting rules for eligibility, benefit formulas, and other parameters rather than by appropriating specific dollar amounts each year. The Congressional Budget Office's (CBO's) baseline projections of mandatory spending assume that existing laws and policies will remain unchanged and that most expiring programs will be extended. Mandatory spending also includes offsetting receipts—fees and other charges that are recorded as negative budget authority and outlays. Offsetting receipts differ from revenues in that revenues are collected as an exercise of the government's sovereign powers, whereas offsetting receipts are generally collected from other government accounts or paid by the public for business transactions (such as rent payments and royalties from leases for oil and gas drilling on the Outer Continental Shelf).

**Discretionary spending** is controlled by annual appropriation acts; policymakers decide each year how many dollars to devote and to which activities. Appropriations fund a wide variety of governmental activity, including defense, transportation, national parks, law enforcement, disaster relief, and foreign aid. Certain fees and other charges that are triggered by appropriation action are classified as offsetting collections, which offset discretionary spending. CBO's baseline depicts the path of discretionary spending in accordance with provisions of the Balanced Budget and Emergency Deficit Control Act of 1985, which state that current spending should be assumed to grow with inflation in the future.[1] CBO estimates that appropriations provided to date total $840 billion for 2005—$421 billion for defense and $419 billion for nondefense activities. In addition, the baseline includes about $45 billion in obligation limitations that control spending from the Highway Trust Fund and the Airport and Airway Trust Fund. Such spending is classified as discretionary, although the budget authority for such programs is provided in authorizing legislation and is considered mandatory.

**Net interest** includes interest paid on Treasury securities and other interest that the government pays (for example, on late refunds issued by the Internal Revenue Service) minus interest that the government collects from various sources (such as from commercial banks, where Treasury tax and loan accounts are maintained). Net interest is determined by the size and composition of the government's debt, annual budget deficits or surpluses, and market interest rates.

1. The inflation rates used in CBO's baseline, as specified by the Deficit Control Act, are the employment cost index for wages and salaries (applied to expenditures related to federal personnel) and the GDP deflator (for other expenditures).

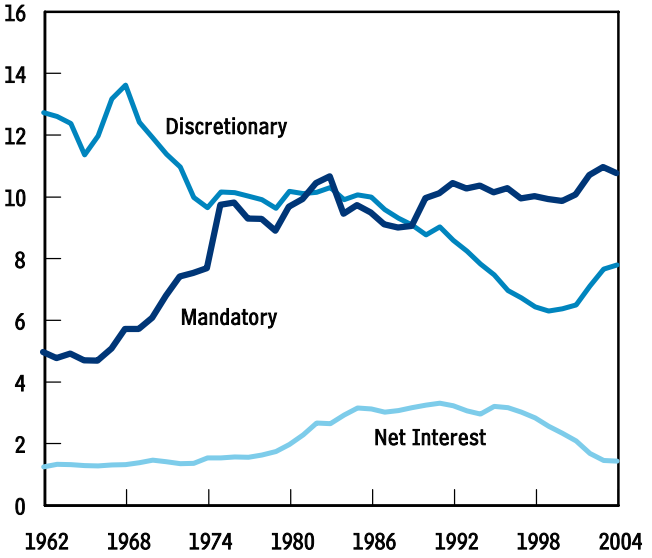
in 1962. At that time, direct spending accounted for 26 percent of outlays; by 2015, CBO estimates that such spending will make up 62 percent of outlays. Expressed as a percentage of GDP, mandatory outlays are projected to rise from 10.7 percent in 2004 to 11.7 percent by 2015. The corresponding figure for 1962 was only 4.9 percent of GDP.

Driving the projected increase in mandatory spending are mounting costs for health care and income support for the elderly, the disabled, and low-income populations. The largest of those programs—Social Security, Medicare, and Medicaid—accounted for 72 percent of mandatory spending in 2004 (excluding offsetting receipts). Buoyed by the rapidly rising costs of health care and an increase in the elderly population, that share will grow steadily over the next 10 years. Under CBO's baseline projections, those three programs will constitute 80 percent of all mandatory spending by 2015—an increase of about 7 percent each year.

**Figure 3-1.**

## Major Components of Spending, 1962 to 2004

(Percentage of GDP)




Source: Congressional Budget Office based on data from the Office of Management and Budget.

### Medicare and Medicaid

Significant federal resources are devoted to health care benefits for the nation's elderly, poor, and disabled. Combined, the Medicare program and the federal government's share of Medicaid currently approach Social Security in size. However, because Medicare and Medicaid will grow much more rapidly—by about 8.5 percent annually, compared with 5.6 percent for Social Security—they are projected to overtake that income-support program by next year. Their cost to the federal government will reach 130 percent of Social Security spending by 2015, CBO estimates (see Table 3-3).

**Medicare.** Spending for Medicare, the primary program that subsidizes medical care for the elderly and certain disabled individuals, is expected to grow rapidly over the next 10 years. The program is currently about 60 percent as large as Social Security (not including the effect of premium collections), but, by 2015, that proportion is projected to reach 86 percent. By then, spending for Medicare will total $766 billion, CBO projects, or almost 4 percent of GDP.

Medicare currently comprises two main parts—Part A (Hospital Insurance) and Part B (Supplementary Medical Insurance). However, the program will undergo a major expansion of benefits in 2006 when it begins to pay for outpatient prescription drugs under the recently approved Part D.[1] Expenditures for Part D will total $47 billion (not including income from premium payments and other offsetting receipts) in 2006, climbing to $174 billion in 2015, CBO estimates.[2] By that time, Part D expenditures will make up 23 percent of spending for Medicare. Overall, spending for Medicare is expected to rise by 9 percent in 2005 and by a similar annual average through 2015. About 40 percent of the upswing in 2005 stems from automatic updates and legislated increases in payment rates for most types of care in the fee-for-service sector (including hospital care and services provided by physicians, home health agencies, and skilled nursing facilities). Those rates are subject to annual revisions based on changes in the prices of goods and services used by providers, as well as on changes in economic factors such as GDP and productivity. Growth in the number of beneficiaries also will account for an increasing share of the rising costs for Medicare, particularly as more baby boomers reach the age at which they qualify for benefits, beginning in 2011.

The projected acceleration of Medicare spending would be even more dramatic were it not for the formula used to establish a fee schedule for physicians' services—the sustainable growth rate (SGR) formula. That formula sets a cumulative spending target for physicians' services and other services related to physician visits (such as laboratory tests and physician-administered drugs). Left unaltered, the SGR formula ultimately recoups spending that exceeds the cumulative target by reducing payment rates for physicians' services or by holding increases below in-

1. Part C of Medicare specifies the rules under which certain private health care plans can assume responsibility, and get paid, for providing the benefits covered under Parts A, B, and D.

2. The transitional Part D program will expire when the outpatient prescription drug program is implemented in January 2006. Spending on the transitional program will total less than $200 million in 2006; spending on the outpatient prescription drug program will total $47 billion during the last three quarters of that fiscal year, CBO estimates.

## Table 3-3.

# CBO's Baseline Projections of Mandatory Spending

(Billions of dollars)

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Social Security | 492 | 517 | 540 | 564 | 592 | 623 | 659 | 697 | 739 | 785 | 835 | 888 | 2,978 | 6,922 |
| Medicare[a] | 297 | 325 | 380 | 426 | 453 | 484 | 520 | 565 | 598 | 654 | 708 | 766 | 2,263 | 5,554 |
| Medicaid | 176 | 186 | 193 | 205 | 223 | 241 | 262 | 284 | 307 | 333 | 361 | 392 | 1,124 | 2,802 |
| Income Security | | | | | | | | | | | | | | |
| Unemployment compensation | 43 | 33 | 35 | 38 | 41 | 42 | 45 | 47 | 49 | 51 | 54 | 56 | 200 | 457 |
| Supplemental Security Income | 34 | 39 | 37 | 35 | 40 | 42 | 43 | 49 | 42 | 48 | 50 | 52 | 198 | 439 |
| Earned income and child tax credits | 42 | 48 | 48 | 48 | 48 | 48 | 48 | 48 | 33 | 33 | 34 | 34 | 240 | 421 |
| Food Stamps | 29 | 32 | 32 | 32 | 32 | 33 | 33 | 34 | 35 | 36 | 37 | 38 | 162 | 342 |
| Family support[b] | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 25 | 26 | 26 | 26 | 124 | 252 |
| Child nutrition | 12 | 13 | 13 | 14 | 14 | 15 | 16 | 16 | 17 | 18 | 18 | 19 | 71 | 159 |
| Foster care | 6 | 7 | 7 | 7 | 8 | 8 | 8 | 9 | 9 | 9 | 10 | 10 | 38 | 84 |
| Subtotal | 191 | 196 | 197 | 199 | 207 | 212 | 218 | 228 | 211 | 221 | 228 | 234 | 1,033 | 2,155 |
| Other Retirement and Disability | | | | | | | | | | | | | | |
| Federal civilian[c] | 60 | 64 | 67 | 70 | 73 | 76 | 80 | 83 | 86 | 89 | 93 | 96 | 365 | 813 |
| Military | 37 | 39 | 41 | 43 | 44 | 46 | 47 | 49 | 50 | 51 | 52 | 53 | 221 | 476 |
| Veterans'[d] | 31 | 35 | 34 | 32 | 34 | 35 | 35 | 38 | 34 | 37 | 38 | 38 | 170 | 355 |
| Other | 7 | 7 | 8 | 8 | 8 | 9 | 9 | 10 | 10 | 11 | 11 | 12 | 43 | 97 |
| Subtotal | 135 | 145 | 149 | 152 | 160 | 166 | 171 | 180 | 180 | 188 | 194 | 200 | 799 | 1,741 |
| Other Programs | | | | | | | | | | | | | | |
| Commodity Credit Corporation Fund | 9 | 22 | 19 | 17 | 15 | 15 | 15 | 14 | 14 | 14 | 14 | 13 | 81 | 149 |
| TRICARE For Life | 5 | 6 | 7 | 7 | 8 | 8 | 9 | 10 | 10 | 11 | 12 | 13 | 39 | 96 |
| Student loans | 8 | 10 | 6 | 7 | 7 | 7 | 7 | 7 | 8 | 8 | 8 | 8 | 34 | 74 |
| Universal Service Fund | 3 | 6 | 7 | 7 | 7 | 7 | 7 | 7 | 8 | 8 | 8 | 8 | 35 | 73 |
| State Children's Health Insurance | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 26 | 52 |
| Social services | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 24 | 49 |
| Other | 20 | 17 | 13 | 14 | 14 | 14 | 14 | 13 | 13 | 12 | 12 | 13 | 69 | 133 |
| Subtotal | 55 | 71 | 62 | 61 | 61 | 62 | 62 | 63 | 64 | 63 | 65 | 65 | 308 | 627 |
| Offsetting Receipts | -109 | -122 | -140 | -159 | -167 | -168 | -179 | -191 | -203 | -217 | -231 | -244 | -813 | -1,899 |
| **Total Mandatory Spending** | **1,237** | **1,317** | **1,380** | **1,450** | **1,529** | **1,620** | **1,713** | **1,824** | **1,896** | **2,028** | **2,159** | **2,303** | **7,692** | **17,902** |
| **Memorandum:** | | | | | | | | | | | | | | |
| Mandatory Spending Excluding Offsetting Receipts | 1,346 | 1,439 | 1,521 | 1,608 | 1,696 | 1,788 | 1,892 | 2,015 | 2,099 | 2,245 | 2,390 | 2,546 | 8,505 | 19,801 |

Source: Congressional Budget Office.

Note: Spending for the benefit programs shown above generally excludes administrative costs, which are discretionary.

a. Excludes offsetting receipts.

b. Includes Temporary Assistance for Needy Families and various programs that involve payments to states for child support enforcement and family support, child care entitlements, and research to benefit children.

c. Includes Civil Service, Foreign Service, Coast Guard, and other small retirement programs and annuitants' health benefits.

d. Includes veterans' compensation, pensions, and life insurance programs.

flation (as measured by the Medicare economic index).[3] If spending falls short of the cumulative target, the SGR formula provides for increases in payment rates above inflation.

Application of the SGR formula resulted in a 5.4 percent reduction in payment rates in 2002 and would have resulted in a 4.4 percent reduction in 2003 if not for legislative intervention. In the Consolidated Appropriations Resolution for 2003 (Public Law 108-7), the Congress responded to that imminent reduction by allowing the Administration to boost the cumulative target—thereby producing a 1.6 percent increase in payment rates for physicians' services for 2003. Application of the SGR formula would have again resulted in reduced payment rates in 2004. However, in the Medicare Prescription Drug, Improvement, and Modernization Act (P.L. 108-173), the Congress specified that payment rates would increase by 1.5 percent in both 2004 and 2005. CBO estimates that spending subject to the SGR formula will exceed the cumulative target by about $20 billion at the end of 2005. As a result, unless it is once again modified, the SGR formula will reduce payment rates for several years, beginning in 2006, and it will keep updates below inflation through at least 2015.

**Medicaid.** Federal outlays for Medicaid, the joint federal-state program that subsidizes the medical care of many of the nation's poor, totaled $176 billion in 2004, making up about 13 percent of mandatory spending (not including offsetting receipts). In the past two years, Medicaid outlays grew at an annual rate of between 9 percent and 10 percent, reflecting continued increases in enrollment and payment rates, and increases in payments to hospitals that serve a disproportionate share of Medicaid beneficiaries or other low-income people. Some of the growth in 2004 was the result of an additional three fiscal quarters of increased federal matching rates established by the Jobs and Growth Tax Relief Reconciliation Act of 2003. Those enhancements boosted 2004 outlays by about $6 billion. (Increased matching funds in 2003 accounted for an estimated $4 billion in spending in the last two quarters of that year.)

Growth in Medicaid outlays in 2005 will be slower than in the program's recent history, CBO estimates, in large part because the temporarily enhanced matching rates expired on June 30, 2004. Spending increases will remain lower through 2007 because the new Medicare drug benefit will replace Medicaid payments for individuals who are eligible for both programs.

Despite those temporary declines, Medicaid spending increases in later years are projected to return to historic levels as a result of rising prices, greater consumption of services, and, to a lesser extent, increased enrollment. After 2007, spending will increase by an average of 8.4 percent annually, CBO projects, rising to $392 billion in 2015. Consequently, the federal government's Medicaid outlays are projected to reach 2.0 percent of GDP by 2015, compared with 1.5 percent in 2004.

### Social Security

Social Security is currently the largest of all federal programs. Its two major components—Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI)—provided benefits of over $487 billion to the elderly and the disabled in 2004. The number of people receiving benefits, already at more than 47 million, is expected to reach 60 million by 2015. Most Social Security beneficiaries also participate in Medicare. Because about 60 percent of people ages 62 to 64, and more than 90 percent of people age 65 and over, collect Social Security benefits, CBO ties its estimates of Social Security beneficiaries primarily to projections of the elderly population.

In the next 10 years and beyond, benefit payments for Social Security are expected to rise at increasingly rapid rates, starting with growth of 5.1 percent in 2005 and climbing to 6.4 percent by 2015.[4] The program's rate of growth will accelerate in the latter half of the 10-year projection period. While both OASI and DI will continue to be affected by the aging of the nation's workforce, DI will realize more growth earlier because aging workers may become disabled before they qualify for OASI.

3. The Medicare economic index measures changes in the costs of physicians' time and operating expenses; it is a weighted sum of the price of inputs in those two categories. Most of the components of the index come from the Bureau of Labor Statistics. Changes in the costs of physicians' time are measured through changes in nonfarm labor costs. Changes in productivity are also factored directly into the index.

4. A discussion of long-term projections for Social Security is presented in Congressional Budget Office, *The Outlook for Social Security* (June 2004).

**Old-Age and Survivors Insurance.** About $411 billion in OASI benefits were paid in 2004 to just under 40 million people. The OASI program pays benefits to workers who reach a defined age of retirement, to their eligible spouses and children, and to some survivors (primarily aged widows and young children) of deceased workers.

Over the past 10 years, outlays for OASI benefits increased at an annual rate of 4.1 percent. The OASI growth rate fell below that average in recent years, chiefly because of low inflation (cost-of-living adjustments—or COLAs—for Social Security benefits are based on inflation), but it is expected to increase considerably, reaching 6.7 percent by 2015.[5] Although much of the projected growth is attributable to wage increases (which raise initial retirement benefits) and COLAs, growth in the number of people receiving OASI will become increasingly responsible for the surge in OASI spending over the next 10 years, particularly once the leading edge of the baby-boom generation begins to collect benefits in 2008.[6] By 2015, CBO projects, nearly 50 million people will be receiving OASI benefits, 25 percent more than in 2004.

**Disability Insurance.** The Social Security program also provides Disability Insurance benefits to qualified workers who have suffered a serious medical impairment that restricts their ability to work before they reach retirement age. DI benefits are also paid to those workers' eligible spouses and children. In 2004, DI benefits totaled roughly $76 billion or about 16 percent of spending for all Social Security benefits. Payments for DI benefits are expected to grow at a rapid clip this year (nearly 10 percent), moderating to around 6 percent in 2006. The marked growth in 2005 continues the rapid pace of recent years, which results partially from unusually large payments for retroactive claims. CBO projects slower growth in DI outlays in 2006, mainly because the backlog of pending cases is expected to shrink in 2005. (Retroactive claims will continue to be made throughout the next 10 years, but with a reduction in the backlog, amounts paid are likely to be smaller.) The lower COLA expected in December 2005—2.3 percent, compared with 2.7 percent in December 2004—also will slow the rate of benefit increases. CBO estimates that growth in DI will taper off to about 5.3 percent by 2015. By that time, the last of the baby boomers will have entered the age category in which disabilities are more likely to occur. Another factor contributing to much of the projected growth in Disability Insurance is the ongoing rise in Social Security's "normal retirement age"—from 65 to 66 and eventually to 67. That increase delays the reclassification of disabled workers as retired workers, and, as a result, older disabled individuals receive benefits under DI for a longer time before making the transition to OASI.

## Other Income-Security Programs

In contrast to the rapid increases in outlays for Social Security, Medicare, and Medicaid, spending for other income-security programs will grow modestly at an average annual rate of 1.8 percent, CBO estimates. (Those programs include unemployment compensation, Supplemental Security Income, the refundable portion of certain tax credits, and Food Stamps.) As a result, those programs will make up a declining share of GDP—falling from about 1.7 percent in 2004 to 1.2 percent by 2015. Some of the drop over time is the result of provisions in law that affect the child tax credit, which is scheduled to expire in 2010. (The amount of the child tax credit that exceeds an individual's tax liability is treated as an outlay in the budget.) Moreover, some major benefit programs (for example, Temporary Assistance for Needy Families, or TANF) are capped by law and thus do not adjust according to increases in inflation or for changing caseloads. Still other programs, such as the refundable portion of the earned income tax credit (EITC), are projected to remain at roughly the same nominal amount over the next 10 years, though they are not capped. Consequently, as the economy expands, spending on those programs will drop relative to GDP.

**Unemployment Compensation.** Following the expiration of a temporary increase in the availability of unemployment benefits in 2004, and with the improving labor market, CBO expects that outlays for unemployment compensation in 2005 will be significantly lower than in recent years. Spending on unemployment compensation will fall to $33 billion this year, CBO estimates, dropping from $55 billion in 2003 and $43 billion in 2004. CBO projects that benefits will gradually rise thereafter as a re-

5. The cost-of-living adjustment for calendar year 2005 is 2.3 percent. CBO estimates that those adjustments, which are pegged to the consumer price index, will be 2.0 percent in 2006 and 2.2 percent in 2007 and thereafter.

6. The oldest members of the baby-boom generation—those born in 1946—will turn 62 in 2008 and thus will qualify for reduced OASI benefits beginning that year. The age at which those individuals can receive full Social Security benefits (the "normal retirement age") is 66.

sult of increases in the amount of average benefits and growth in the labor force.

**Supplemental Security Income.** Outlays for the Supplemental Security Income program, which provides cash benefits to low-income people with disabilities, reached nearly $34 billion in 2004. SSI spending is projected to increase at an average rate of 3.0 percent annually during the 2006-2015 period, though spending in a given year can fluctuate according to the number of payments made in that year. The program's growth is driven mainly by cost-of-living adjustments and a rising caseload.

**Earned Income and Child Tax Credits.** Taxpayers who earn wages below an established maximum, and those with dependent children, are eligible for federal tax credits. While a portion of those credits reduces filers' overall tax liability, the portion that exceeds that tax liability may be refunded to them in the form of a cash payment and thus is categorized as an outlay in the federal budget. The refundable portions of the earned income and child tax credits totaled $42 billion in 2004. About $33 billion of that amount represented the refundable portion of the earned income tax credit, while $9 billion was attributable to the child tax credit. CBO estimates that much of the recent growth in participation in those programs will persist and that outlays for the credits will total $48 billion in 2005. Under the Working Families Tax Relief Act of 2004, the child tax credit was increased to $1,000 for calendar years 2005 through 2009 (matching the amount of the credit in 2004 and 2010). As a result, CBO expects that outlays for the two credits will remain steady at about $48 billion until fiscal year 2012. By then, the child tax credit will be virtually eliminated under current law, and scheduled higher taxes will reduce the refundable portion of the EITC. Consequently, outlays for those credits will drop to about $33 billion annually.

**Food Stamps.** CBO anticipates that outlays for the Food Stamp program will rise by 12 percent—to $32 billion—in 2005 following a similar jump in 2004. In recent years, participation in the Food Stamp program has increased much faster than expected. CBO projects that participation in the program will continue at a higher level throughout the coming years and that spending for the program will remain well above its prerecession range of $18 billion to $19 billion per year.

**Family Support Services.** The federal government provides grants to states to help fund services to families. Outlays for those family support services—Temporary Assistance for Needy Families, child support enforcement, and other child care entitlements—totaled $25 billion in 2004 and are estimated to remain at about the same level in 2005. Because the largest of those programs—TANF—is capped, spending in this category is expected to stay fairly flat throughout the next 10 years. Authorization for TANF originally was scheduled to expire at the end of 2002, but the program was extended at various points in the past two years and now is authorized through March 31, 2005. As required by the Deficit Control Act, CBO assumes that funding for TANF will continue at its most recently authorized level of nearly $17 billion per year.

**Child Nutrition and Foster Care.** Spending for both child nutrition and for foster care and adoption assistance (neither of which is capped) is projected to rise by about 4 percent a year through 2015. In 2004, outlays for child nutrition programs were $12 billion. They are expected to rise to $13 billion in 2005. Spending for foster care and adoption assistance totaled a little over $6 billion in 2004 and is estimated to be about $7 billion in 2005.

### Other Federal Retirement and Disability Programs

Benefits for federal retirees—both civilian and military—totaled $135 billion in 2004 and are estimated to reach $145 billion in 2005. Between 2006 and 2015, funding for those programs is projected to grow steadily at about 3.3 percent per year and to remain at roughly 1 percent of GDP.

In 2004, the federal government funded nearly $60 billion in annuities and survivors' benefits through its civilian retirement program, along with several smaller retirement programs for employees of various government agencies. Those payments are expected to grow to more than $96 billion by 2015. The increase is fed by growth in the number of beneficiaries, cost-of-living adjustments, and rising federal salaries (which, in turn, boost future benefit levels). One factor that restrains growth somewhat is the gradual replacement of the Civil Service Retirement System (CSRS) with the smaller defined ben-

efit provided under the Federal Employees' Retirement System (FERS).[7]

In addition, the government offers benefits to retired military personnel and veterans. Annuities paid to retired military personnel reached $37 billion in 2004. They are estimated to total $39 billion in 2005 and are expected to rise to $53 billion by 2015—an increase of about 3.2 percent a year. Mandatory spending for veterans' benefits—including disability compensation, pensions, and dependency and indemnity compensation to surviving spouses and children—totaled $31 billion in 2004 and is projected to climb to $38 billion by 2015, mainly because of cost-of-living adjustments and caseload increases.

### Other Mandatory Spending

After an initial increase in 2005, other mandatory spending is expected to stay between $61 billion and $65 billion a year through 2015. Spending for farm price and income supports administered through the Commodity Credit Corporation (CCC) is projected to jump from $9 billion in 2004 to $22 billion in 2005. Because of near-record-high crop prices in 2004, the CCC paid out relatively little in federal subsidies. However, with a rapid drop in crop prices evident for 2005, CBO estimates that federal spending will increase significantly before returning to levels of $13 billion to $15 billion annually.

By contrast, outlays for the TRICARE For Life program—which provides health care benefits to retirees of the uniformed services who are eligible for Medicare (and to their dependents and surviving spouses)—are expected to grow rapidly each year, rising from $6 billion in 2005 to $13 billion by 2015. (At about 8 percent, the program's rate of growth parallels that of other medical expenditures.) Other mandatory spending is not expected to change significantly. For example, CBO estimates that, from 2006 to 2015, the subsidy and administrative costs of student loan programs will range from $6 billion to $8 billion a year.[8]

### Offsetting Receipts

Offsetting receipts are payments from the public or from intragovernmental transactions that, for budgetary purposes, the federal government characterizes and records as negative spending. In other words, those payments offset mandatory spending. Examples of such receipts include beneficiaries' premium payments for Medicare, federal agencies' contributions to retirement funds, and the government's receipts for the harvesting of timber and extraction of minerals on federal lands. The collection of offsetting receipts reduces total mandatory spending by between 8 percent and 10 percent each year.

**Medicare Premiums and Related Receipts.** Over the 10-year projection period, premiums for the Medicare program make up the largest component of offsetting receipts (see Table 3-4). In 2004, those payments totaled $32 billion and offset Medicare spending by about 11 percent. By 2015, when such premiums and other payments to Medicare are projected to reach $130 billion, they will reduce the program's overall costs by about 17 percent. Most of the increase over the coming 10 years is attributable to the prescription drug premiums and other collections provided under the new Medicare Part D.

Only a small portion of Medicare premiums—about 5 percent—are collected under Part A, the Hospital Insurance program. That proportion will fall to 3 percent by 2015 as premiums collected under Part D become a more significant source of receipts.

The majority of Medicare premiums are paid by the 39 million people enrolled in Supplementary Medicare Insurance (Medicare Part B), which covers physicians' and outpatient hospital services. By law, those premiums are set to cover one-quarter of that program's costs. In 2005, the average monthly premium is $78; it is expected to grow to $125 by 2015. Beginning in 2007, beneficiaries with relatively high incomes will be charged higher premiums. By 2015, CBO estimates, about 6 percent of beneficiaries will have annual incomes that are subject to those higher premiums, which will be as high as $365 a month. Total Part B premiums are projected to rise from $36 billion in 2005 to about $80 billion in 2015.

7. Beginning in 1984, all newly hired federal civilian employees were enrolled in the FERS program. Although benefits under FERS by itself are lower than under CSRS, people enrolled in FERS are covered by Social Security and have contributions to the Thrift Savings Plan matched in part by their employing agencies.

8. The costs that are included in the federal budget for student loans are the present value of the net costs associated with the $765 billion in direct and guaranteed loans expected over the 10-year projection period. Under the Credit Reform Act, only the subsidy costs of the loans are treated as outlays. Those outlays are estimated as the future costs in today's dollars for interest subsidies, default costs, and other expected expenses over the life of the loans.

**Table 3-4.**

## CBO's Baseline Projections of Offsetting Receipts

(Billions of dollars)

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Medicare[a] | -32 | -38 | -55 | -64 | -69 | -75 | -82 | -90 | -98 | -107 | -118 | -130 | -346 | -890 |
| Employers' Share of Employees' Retirement | | | | | | | | | | | | | | |
| Social Security | -11 | -11 | -12 | -12 | -13 | -14 | -15 | -16 | -17 | -18 | -19 | -21 | -67 | -159 |
| Military retirement | -14 | -16 | -16 | -15 | -16 | -16 | -17 | -17 | -18 | -18 | -18 | -18 | -80 | -169 |
| Civil service retirement and other | -20 | -19 | -20 | -21 | -22 | -23 | -24 | -25 | -26 | -27 | -28 | -29 | -110 | -244 |
| Subtotal | -45 | -47 | -48 | -49 | -51 | -53 | -56 | -59 | -61 | -63 | -66 | -68 | -257 | -573 |
| TRICARE For Life | -8 | -10 | -11 | -12 | -12 | -13 | -14 | -15 | -16 | -17 | -18 | -19 | -62 | -145 |
| Electromagnetic Spectrum Auctions | 0 | 0 | 0 | -8 | -8 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | -15 | -15 |
| Energy-Related Receipts[b] | -6 | -8 | -8 | -8 | -8 | -8 | -8 | -9 | -9 | -10 | -10 | -10 | -41 | -88 |
| Natural-Resources-Related Receipts[c] | -5 | -5 | -5 | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -4 | -22 | -43 |
| Other[d] | -12 | -14 | -14 | -14 | -14 | -14 | -15 | -15 | -15 | -15 | -16 | -13 | -70 | -145 |
| **Total** | **-109** | **-122** | **-140** | **-159** | **-167** | **-168** | **-179** | **-191** | **-203** | **-217** | **-231** | **-244** | **-813** | **-1,899** |

Source: Congressional Budget Office.

a. Includes Medicare premiums and amounts withheld from payments to states' Medicaid programs and transferred to the Part D account in the Supplementary Medical Insurance Trust Fund.

b. Includes proceeds from the sale of electricity, various fees, and Outer Continental Shelf receipts.

c. Includes timber and mineral receipts and various fees.

d. Includes asset sales.

Beginning in 2006, premium payments for Medicare Part D will total $9 billion. CBO estimates that those payments will cover about one-sixth of the program's costs. Part D collections are expected to grow steadily—by about 9 percent each year—after the new prescription drug benefit is underway, rising to $29 billion in 2015.

With the introduction of Medicare Part D, some of the costs of providing prescription drug coverage to low-income Medicare enrollees will shift from the Medicaid program (which the states and the federal government both fund) to Medicare. Current law requires a portion of the resulting savings to be withheld from federal payments to state Medicaid programs and credited to the Medicare Part B trust fund. CBO projects that those transfers will grow from $6 billion in 2006 to $18 billion in 2015.

**Other Offsetting Receipts.** In 2004, intragovernmental transfers from federal agencies to employee retirement plans made up the largest component of offsetting receipts. Those payments will total about $47 billion in 2005, constituting about 38 percent of total offsetting receipts that year. Those intragovernmental transfers will continue to rise, totaling a projected $68 billion in 2015. Agencies' retirement contributions are primarily paid to the trust funds for Social Security, military retirement, and civil service retirement. They are charged against the agencies' budgets in the same way that other elements of their employees' compensation are: the budget treats them as outlays of the employing agency and records the deposits in the retirement funds as offsetting receipts. The transfers net to zero in budgetary totals, leaving only the funds' disbursements—for retirement benefits and administrative costs—reflected as outlays.

As they do with their retirement plans, the Department of Defense and certain other agencies make intragovernmental transfers to the Uniformed Services Medicare-Eligible Retiree Health Care Fund under the TRICARE For Life program. Its receipts are expected to almost double, rising from about $10 billion in 2005 to nearly $19 billion in 2015.

The auction of rights to use portions of the electromagnetic spectrum constitutes another source of offsetting receipts. Such auctions are expected to continue until the Federal Communications Commission's (FCC's) authority expires at the end of 2007. CBO assumes that the FCC will auction at least 90 megahertz of spectrum for advanced wireless services sometime in 2006 and 2007. Those auctions will bring in about $15 billion through 2015, with the receipts being tallied in 2007 and 2008.

Other sources of proprietary receipts include royalties from and charges for oil and natural-gas production on federal lands; sales from federal hydroelectric facilities; sales arising from the harvesting of timber and extraction of minerals on federal lands; and various fees levied on users of public property and services. Energy-related receipts are expected to come to between $8 billion and $10 billion per year, while those dealing with natural resources will bring in about half as much, CBO estimates. A variety of other receipts are expected to average about $14 billion annually through 2015.

## What Drives the Growth in Mandatory Spending?

Mandatory spending has a history of rapid growth. For example, over the past 10 years, mandatory spending (excluding offsetting receipts) grew at a rate of 5.5 percent per year, which outpaced nominal growth in the economy. CBO expects that trend to continue well into the future, with growth between 2005 and 2015 reaching levels slightly above the recent average. Overall, CBO estimates that, by 2015, spending on mandatory programs will exceed the amount projected for 2005 by $1.1 trillion. The bulk of that increase—75 percent—is attributable to rising per-beneficiary costs. Expanding caseloads will account for about one-fourth of the increase between 2006 and 2015 (see Table 3-5).

**Increases in Spending per Recipient.** CBO anticipates that most mandatory programs will continue to see increases in per-beneficiary costs. Such spending is frequently required by factors set in law (COLAs and other automatic adjustments, for instance). Other contributing factors include rising wages (which are used as a basis for determining benefit levels in several programs); increases in the intensity of benefit utilization; the addition of more-costly medical procedures; and the expansion of benefits. CBO estimates that, by 2015, those increases will boost spending by $830 billion—a 58 percent jump. Thus, those factors account for average annual growth of about 4.7 percent in mandatory spending—more than twice the projected rise in the consumer price index. Just over 60 percent of such increases—about $500 billion—will be attributable to funding for Medicare and Medicaid (not accounting for the offsetting receipts that reduce the net cost of those programs). A significant portion of that increase can be ascribed to the addition of the outpatient prescription drug program, Medicare Part D.

Increases in average benefits for Social Security account for another $251 billion in rising per-beneficiary costs. Average benefits for Social Security recipients (and for most federal retirees) grow faster than the increase provided by COLAs alone because initial awards to new beneficiaries are indexed to growth in wages, and wage growth typically exceeds inflation.

**Increases in Caseload.** About one-quarter of the growth in mandatory spending over the 2006-2015 period can be attributed to the rising ranks of beneficiaries. Even if average benefits did not rise, adding beneficiaries to the rolls under current eligibility rules would increase spending by $17 billion in 2006 and by $288 billion by 2015, CBO projects, relative to outlays in 2005. That growth amounts to an average of about 2 percent per year. Just over half of the increase in costs from expanding caseloads will occur in the Medicare and Medicaid programs. About 40 percent of the growth in caseloads over the next 10 years will take place in Social Security. CBO estimates that the annual increases in the number of OASI beneficiaries will be about 1 percent at the beginning of the period and then will escalate rapidly, reaching almost 3 percent by 2015.

**Shifts in Payment Dates.** Outlays for mandatory programs also depend on whether the first day of the fiscal year, October 1, falls on a weekday or weekend. If it falls on a weekend, some benefit payments will be made at the end of September—which increases spending for the preceding year and decreases spending for the forthcoming year. Because SSI, veterans' compensation and pension programs, and Medicare payments to health maintenance

**Table 3-5.**

## Sources of Growth in Mandatory Spending

(Billions of dollars)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|---|---|
| Estimated Spending for Base Year 2005 | 1,439 | 1,439 | 1,439 | 1,439 | 1,439 | 1,439 | 1,439 | 1,439 | 1,439 | 1,439 |
| Sources of Growth | | | | | | | | | | |
| Medicare and Medicaid | | | | | | | | | | |
| Establishment of Medicare Part D[a] | 45 | 73 | 83 | 91 | 100 | 110 | 122 | 136 | 153 | 172 |
| Other increases in spending per recipient | 14 | 34 | 57 | 88 | 122 | 160 | 199 | 239 | 283 | 331 |
| Increases in caseload | 8 | 18 | 29 | 41 | 52 | 66 | 84 | 104 | 126 | 149 |
| Social Security | | | | | | | | | | |
| Increases in spending per recipient | 16 | 33 | 52 | 73 | 96 | 121 | 149 | 180 | 214 | 251 |
| Increases in caseload | 7 | 14 | 23 | 34 | 46 | 59 | 73 | 88 | 104 | 120 |
| Income security, federal retirement, disability, and social services[b] | | | | | | | | | | |
| Increases in spending per recipient | 8 | 15 | 24 | 33 | 41 | 51 | 45 | 56 | 66 | 76 |
| Increases in caseload | 2 | 6 | 8 | 10 | 12 | 13 | 15 | 16 | 18 | 19 |
| Shifts in payment dates[c] | -8 | -15 | -9 | -9 | -9 | 3 | -21 | -9 | -9 | -9 |
| Other effects | -10 | -9 | -10 | -10 | -8 | -6 | -6 | -4 | -3 | -2 |
| **Total** | **82** | **169** | **257** | **349** | **453** | **576** | **660** | **806** | **951** | **1,107** |
| Projected Spending | 1,521 | 1,608 | 1,696 | 1,788 | 1,892 | 2,015 | 2,099 | 2,245 | 2,390 | 2,546 |
| **Memorandum:** | | | | | | | | | | |
| Total Increases in Spending per Recipient | 83 | 155 | 216 | 283 | 359 | 441 | 515 | 611 | 715 | 830 |
| Total Increases in Caseload | 17 | 39 | 60 | 85 | 111 | 139 | 172 | 209 | 248 | 288 |

Source: Congressional Budget Office.

Note: Amounts do not include the effects of offsetting collections.

a. Gross Part D spending is substantially larger than the effect on the federal budget of establishing the Medicare prescription drug benefit because gross Part D spending includes some costs that, under prior law, would have been incurred by Medicaid and other federal health programs. It does not, however, include offsetting receipts of the Medicare program from new premiums and payments by states.

b. This category includes unemployment compensation, earned income and child tax credits, military and civilian retirement, veterans' benefits, child nutrition, Food Stamps, and foster care.

c. Represents baseline differences attributable to assumptions about the number of benefit checks that will be issued in a fiscal year. Normally, benefit payments are made once a month. However, Medicare will pay 13 months of benefits in 2005 and 2011 and 11 in 2006 and 2012. Supplemental Security Income and veterans' benefits will be paid 13 times in 2005 and 2011 and 11 times in 2007 and 2012.

organizations all are affected by such calendar shifts, those programs may send out 11, 12, or 13 monthly checks in a fiscal year. Irregular numbers of benefit payments will affect mandatory spending in 2005, 2006, 2007, 2011, and 2012. Those effects reduce outlays in most later years relative to those in 2005, in large part because 2005 is a 13-payment year.

Other changes to mandatory programs will reduce outlays over the 2006-2015 period. Those changes are largely attributable to spending by the Commodity Credit Corporation, which CBO projects will decline after this year. Also, CBO has recorded outlays of $7 billion in 2005 to adjust for revised estimates of the costs of credit programs; such costs are not included in future years.

### Legislation Assumed in the Baseline

CBO's projections for mandatory spending follow the general baseline concept of estimating future budget au-

thority and outlays in accordance with current law. However, in the case of certain mandatory programs with outlays of more than $50 million in the current year, the Deficit Control Act directs CBO to assume that the programs will be extended when their authorization expires.[9]

The Food Stamp program, Temporary Assistance for Needy Families, the agricultural price and income-support programs of the Commodity Credit Corporation, rehabilitation services and disability research, and the State Children's Health Insurance Program are examples of programs whose current authorization is set to expire but in the baseline is assumed to continue. The Deficit Control Act also directs CBO to assume that a cost-of-living adjustment for veterans' compensation is granted each year. The assumption that expiring programs will continue accounts for nearly $6 billion in outlays in 2005. As authorization for various programs expires throughout the next 10 years, that figure climbs to $87 billion by 2015 (see Table 3-6).

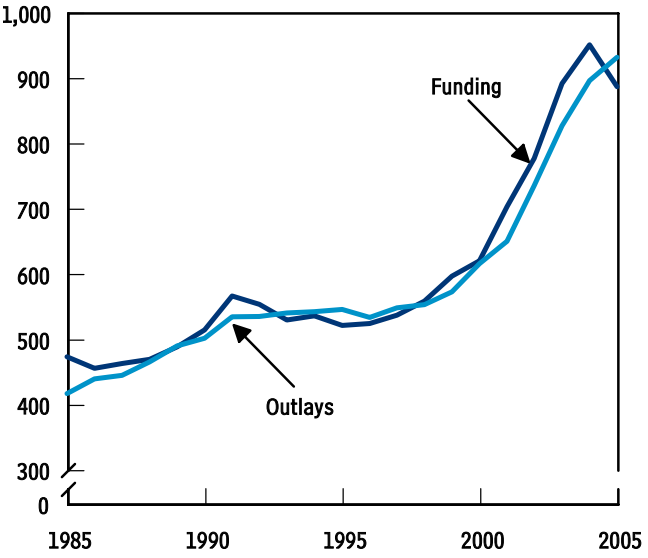
## Discretionary Spending

Each year, the Congress starts the appropriation process anew. The annual appropriation acts that it passes provide new budget authority (authority to enter into financial obligations) for discretionary programs and activities. That authority translates into outlays once the money is actually spent. Although some funds (for example, those designated for employees' salaries) are spent quickly, others (for example, those intended for major construction projects) are disbursed over several years. In any given year, discretionary outlays include spending from both new budget authority and from amounts previously appropriated.

**Figure 3-2.**

### Discretionary Funding and Outlays, 1985 to 2005

(Billions of dollars)




Source: Congressional Budget Office.

Note: Discretionary funding includes both budget authority and obligation limitations. (Spending from the Highway Trust Fund and the Airport and Airway Trust Fund is subject to such limitations. Budget authority for those programs is provided in authorizing legislation and is not considered discretionary.)

### Recent Trends in Discretionary Funding and Outlays

In the mid-1980s, discretionary outlays accounted for 10.0 percent of GDP, but by 1999 they had fallen to 6.3 percent (see Table 3-7 on page 69). With the advent of budget surpluses in the late 1990s, funding for discretionary programs began moving upward again, thereby reversing the decline in outlays as a share of the economy (see Figure 3-2). The events of September 11, 2001, accelerated that trend, with discretionary outlays jumping to 7.1 percent of GDP ($734 billion) in 2002 and 7.6 percent ($825 billion) in 2003.

Under baseline assumptions, total discretionary outlays as a share of GDP drop slightly—from 7.7 percent ($895 billion) in 2004 to 7.6 percent ($930 billion) in 2005. However, anticipated additional funding for activities in Iraq and Afghanistan will most likely add about $30 billion to outlays this year. Assuming such funding is enacted, total discretionary outlays would account for about

9. Section 257 of the Deficit Control Act stipulates that programs with current-year outlays of $50 million or more that were established prior to enactment of the Balanced Budget Act of 1997 are assumed in the baseline to continue but that the treatment of programs established after the 1997 law will be decided on a case-by-case basis, in consultation with the House and Senate Budget Committees. For example, the Budget Committees decided not to continue the recently enacted tobacco-buyout payments, which have been authorized through fiscal year 2014 and were estimated to cost about $1 billion annually.

7.9 percent of GDP—the highest level since 1993—and would have a growth rate in 2005 of 7.3 percent.

Trends in overall discretionary spending have generally been greatly influenced by spending on defense. During the late 1980s and the 1990s, such outlays declined sharply as a share of the economy, sliding from a peak of 6.2 percent in 1986 to a low of 3.0 percent between 1999 and 2001. In 2002, those outlays rose to 3.4 percent of GDP and then continued to climb, reaching 3.7 percent in 2003 and 3.9 percent in 2004. Without additional funding for Iraq and Afghanistan, CBO estimates that defense outlays would account for 3.8 percent of GDP in 2005. Additional funding could boost defense outlays by about 8.9 percent over the 2004 level, growing to about 4.0 percent of GDP. Excluding supplemental funding appropriated in 2004 (mostly for activities in Iraq and Afghanistan) and in 2005 (mostly for disaster relief related to hurricane damage), discretionary budget authority for defense programs grew from $394 billion in 2004 to $420 billion in 2005, a 6.7 percent increase (see Table 3-8 on page 70).

Nondefense discretionary programs encompass such activities as housing assistance, transportation, maintenance of national parks, and foreign aid. Spending for such programs has remained relatively constant as a share of GDP since the mid-1980s (generally hovering between 3.2 percent and 3.9 percent of GDP), although it has grown steadily in nominal dollar terms. Such spending is estimated to total 3.8 percent of GDP in 2005. The growth rate of nondefense discretionary outlays slowed significantly in the past two years, dropping from 12.3 percent in 2002 to 4.9 percent in 2004. However, in 2005, CBO projects that growth rate to increase to 5.8 percent, partially as a result of outlays from previous appropriations. Nearly half of the $466 billion in outlays projected for 2005 in the nondefense discretionary category stems from funding granted before this year. Also contributing to the increase in outlays for nondefense discretionary programs is spending for reconstruction activities in Iraq—such outlays are expected to rise from $3 billion in 2004 to $6 billion this year.

Excluding all supplemental funding in 2004 and 2005, appropriations for nondefense discretionary activities have grown by 3.5 percent since last year. Spending on homeland security activities has been among the fastest-growing components of the nondefense discretionary category: excluding supplemental funding, budget authority for such programs jumped by nearly 15 percent in 2005, CBO estimates (see Table 3-8). Appropriations for other nondefense activities have risen by 2.6 percent over the previous year's levels. Areas of growth include Project BioShield (which received an advance appropriation of $2.5 billion last year for fiscal year 2005), hospital and medical care for veterans, and programs to battle HIV/AIDS overseas.[10] A large decrease in funding occurred for election reform programs. (Those programs were not funded in 2005, but about $1 billion in previous funding remains to be spent.)

The distribution of the $464 billion in funding for nondefense discretionary activities for 2005 (including $45 billion in obligation limitations) is shown in Figure 3-3 on page 68. The education, training, employment, and social services category will constitute 17 percent of nondefense discretionary funding ($80 billion) in 2005, CBO projects. That budget function includes all discretionary federal programs related to education and employment, as well as social services for children, families, the elderly, and the disabled. (Student loans, unemployment compensation, and a number of other programs are not included in these totals, because they are considered mandatory programs.) Funding for transportation programs (ground, air, and water)—which includes obligation limitations set in appropriation bills—will total $71 billion and account for 15 percent of nondefense discretionary funding in 2005, CBO estimates. Health research and public health expenditures will reach $54 billion—and make up 12 percent of nondefense discretionary funding—in 2005. According to CBO's calculations, at $46 billion, the income-security category will claim 10 percent of nondefense discretionary funding, mostly for housing assistance and food and nutrition assistance programs. Those four categories together account for over half of all nondefense discretionary funding.

10. Project BioShield also received an advance appropriation of $2.2 billion for 2009.

## Table 3-6.

# Costs for Mandatory Programs That CBO's Baseline Assumes Will Continue Beyond Their Current Expiration Dates

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Food Stamps | | | | | | | | | | | | | |
| Budget authority | n.a. | n.a. | n.a. | 32.0 | 32.6 | 33.4 | 34.2 | 35.1 | 35.9 | 36.9 | 37.8 | 98.0 | 278.0 |
| Outlays | n.a. | n.a. | n.a. | 30.6 | 32.6 | 33.3 | 34.2 | 35.1 | 35.9 | 36.8 | 37.8 | 96.5 | 276.3 |
| Temporary Assistance for Needy Families | | | | | | | | | | | | | |
| Budget authority | 7.1 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 84.6 | 169.2 |
| Outlays | 5.2 | 15.2 | 17.2 | 17.2 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 16.9 | 83.5 | 168.2 |
| Commodity Credit Corporation[a] | | | | | | | | | | | | | |
| Budget authority | n.a. | n.a. | n.a. | n.a. | 15.0 | 14.6 | 14.4 | 14.0 | 13.9 | 13.9 | 12.7 | 29.6 | 98.4 |
| Outlays | n.a. | n.a. | n.a. | n.a. | 15.0 | 14.6 | 14.4 | 14.0 | 13.9 | 13.9 | 12.7 | 29.6 | 98.4 |
| Veterans' Compensation COLAs | | | | | | | | | | | | | |
| Budget authority | n.a. | 0.6 | 1.1 | 1.7 | 2.4 | 3.0 | 3.9 | 4.0 | 4.9 | 5.6 | 6.2 | 8.7 | 33.3 |
| Outlays | n.a. | 0.5 | 1.0 | 1.7 | 2.3 | 2.9 | 3.9 | 3.9 | 4.9 | 5.5 | 6.2 | 8.5 | 32.9 |
| Child Care Entitlement to States | | | | | | | | | | | | | |
| Budget authority | 0.9 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 13.6 | 27.2 |
| Outlays | 0.6 | 2.2 | 2.6 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 | 12.9 | 26.5 |
| State Children's Health Insurance Program | | | | | | | | | | | | | |
| Budget authority | n.a. | n.a. | n.a. | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | 15.1 | 40.3 |
| Outlays | n.a. | n.a. | n.a. | 2.0 | 4.0 | 4.9 | 5.3 | 5.3 | 5.4 | 5.2 | 5.1 | 10.9 | 37.2 |
| Rehabilitation Services and Disability Research | | | | | | | | | | | | | |
| Budget authority | n.a. | n.a. | 2.8 | 2.8 | 2.9 | 3.0 | 3.0 | 3.1 | 3.2 | 3.2 | 3.3 | 11.5 | 27.2 |
| Outlays | n.a. | n.a. | 1.1 | 2.2 | 2.8 | 2.8 | 2.9 | 3.0 | 3.0 | 3.1 | 3.2 | 9.0 | 24.2 |
| Ground Transportation Programs Not Subject to Annual Obligation Limitations | | | | | | | | | | | | | |
| Budget authority | 0.2 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 3.2 | 6.4 |
| Outlays | 0.1 | 0.3 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 2.5 | 5.7 |
| Federal Unemployment Benefits and Allowances | | | | | | | | | | | | | |
| Budget authority | n.a. | n.a. | n.a. | 0.9 | 0.9 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 1.0 | 2.7 | 7.6 |
| Outlays | n.a. | n.a. | n.a. | 0.4 | 0.8 | 0.9 | 0.9 | 0.9 | 1.0 | 1.0 | 1.0 | 2.1 | 7.0 |

Continued

## Table 3-6.
## Continued

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Child Nutrition[b] | | | | | | | | | | | | | |
| Budget authority | 0 | 0 | 0 | 0 | 0 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.6 | 0.5 | 3.1 |
| Outlays | 0 | 0 | 0 | 0 | 0 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 0.6 | 0.4 | 3.0 |
| Family Preservation and Support | | | | | | | | | | | | | |
| Budget authority | n.a. | n.a. | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 1.2 | 2.7 |
| Outlays | n.a. | n.a. | 0.1 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.9 | 2.4 |
| Other Natural Resources | | | | | | | | | | | | | |
| Budget authority | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0.3 | 0 | 0.3 |
| Outlays | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0.2 | 0 | 0.2 |
| Ground Transportation Programs Controlled by Obligation Limitations[c] | | | | | | | | | | | | | |
| Budget authority | 14.2 | 41.3 | 41.3 | 41.3 | 41.3 | 41.3 | 41.3 | 41.3 | 41.3 | 41.3 | 41.3 | 206.7 | 413.3 |
| Outlays | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Air Transportation Programs Controlled by Obligation Limitations | | | | | | | | | | | | | |
| Budget authority | 0 | 0 | 0 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 11.1 | 29.6 |
| Outlays | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Total** | | | | | | | | | | | | | |
| **Budget authority** | **22.4** | **62.2** | **65.8** | **108.1** | **124.4** | **126.0** | **127.6** | **128.3** | **130.0** | **131.7** | **132.5** | **486.5** | **1,136.6** |
| **Outlays** | **5.8** | **18.2** | **22.5** | **57.6** | **78.1** | **80.5** | **82.6** | **83.4** | **85.1** | **86.6** | **87.3** | **256.9** | **681.8** |

Source: Congressional Budget Office.

Notes: n.a. = not applicable; COLAs = cost-of-living adjustments.

a. Agricultural commodity price and income supports under the Farm Security and Rural Investment Act of 2002 (FSRIA) generally expire after 2007. Although permanent price support authority under the Agricultural Adjustment Act of 1939 and the Agricultural Act of 1949 would then become effective, section 257(b)(2)(iii) of the Deficit Control Act says that the baseline must assume that the FSRIA provisions continue.

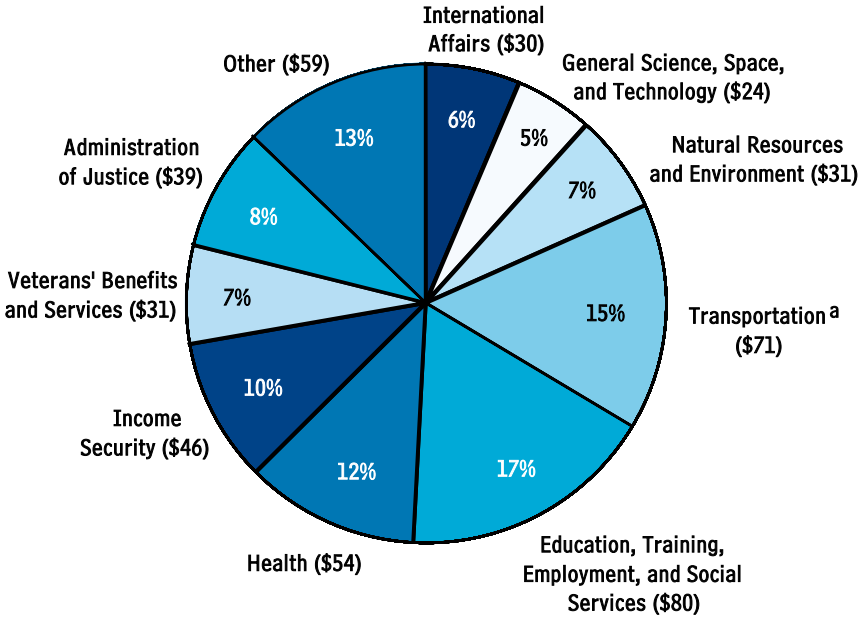
b. Includes the Summer Food Service program and state administrative expenses.

c. Authorizing legislation provides contract authority, which is counted as mandatory budget authority. However, because spending is subject to obligation limitations specified in annual appropriation acts, outlays are considered discretionary.

**Figure 3-3.**

## Nondefense Discretionary Funding, by Budget Function, 2005

(Billions of dollars)




Source: Congressional Budget Office.

a. Includes $45 billion in obligation limitations.

### Discretionary Spending for 2006 Through 2015

Under baseline assumptions, CBO projects that discretionary outlays will drop from $930 billion in 2005 to $914 billion in 2006, before steadily rising for the remainder of the 10-year projection period, reaching $1.1 trillion in 2015. The initial drop-off can be attributed to a projected decline in defense spending in 2006 and 2007 as outlays for Iraq and Afghanistan taper off under the baseline assumption of no additional appropriations for those operations. In 2008, outlays for defense are projected to begin rising again; by 2015, such outlays would total $529 billion.[11] CBO projects that, under baseline assumptions, nondefense discretionary outlays would continue rising steadily throughout the 2006-2015 period, growing from $476 billion in 2006 to $572 billion in 2015—an average rate of 2.1 percent per year.

**Homeland Security.** One type of spending that encompasses both defense and nondefense activities is homeland security.[12] The Administration has identified the spending that it considers related to such activities, and, in its current baseline, CBO has adopted the Administration's classification.[13] Net discretionary budget authority for homeland security is estimated to total about $42 billion in 2005—$11 billion for defense and $31 billion for nondefense programs. CBO estimates that the resulting discretionary outlays for those needs will total $37 billion this year (see Table 3-9 on page 71). In addition, roughly $1 billion in net outlays for homeland security is classified as mandatory spending in 2005. Under its baseline

11. Most spending for defense programs is classified as discretionary; however, an additional $2 billion a year in defense spending is classified as mandatory.

12. For a discussion of homeland security activities and funding, see Congressional Budget Office, *Federal Funding for Homeland Security,* Economic and Budget Issue Brief (April 30, 2004).

13. CBO received some preliminary information from the Administration regarding the classification of appropriations for 2005 for the Department of Homeland Security. For homeland security activities outside of the Department, CBO estimated homeland security spending for 2005 on the basis of the amounts designated for that activity in OMB's 2004 *Mid-Session Review.* Once the Administration releases its 2006 budget proposal in February 2005, CBO will revise its homeland security estimates to reflect the Administration's classification of those programs.

**Table 3-7.**

## Defense and Nondefense Discretionary Outlays, 1985 to 2005

| | Defense Outlays | | | Nondefense Outlays | | | Total Discretionary Outlays | | |
|---|---|---|---|---|---|---|---|---|---|
| | In Billions of Dollars | As a Percentage of GDP | Percentage Change from Previous Year | In Billions of Dollars | As a Percentage of GDP | Percentage Change from Previous Year | In Billions of Dollars | As a Percentage of GDP | Percentage Change from Previous Year |
| 1985 | 253 | 6.1 | 11.0 | 163 | 3.9 | 7.5 | 416 | 10.0 | 9.6 |
| 1986 | 274 | 6.2 | 8.2 | 165 | 3.7 | 1.2 | 439 | 10.0 | 5.5 |
| 1987 | 283 | 6.1 | 3.2 | 162 | 3.5 | -1.8 | 444 | 9.5 | 1.3 |
| 1988 | 291 | 5.8 | 3.0 | 174 | 3.5 | 7.3 | 464 | 9.3 | 4.6 |
| 1989 | 304 | 5.6 | 4.5 | 185 | 3.4 | 6.5 | 489 | 9.0 | 5.2 |
| 1990 | 300 | 5.2 | -1.3 | 200 | 3.5 | 8.5 | 501 | 8.7 | 2.4 |
| 1991 | 320 | 5.4 | 6.5 | 214 | 3.6 | 6.6 | 533 | 9.0 | 6.5 |
| 1992 | 303 | 4.8 | -5.3 | 231 | 3.7 | 8.2 | 534 | 8.6 | 0.1 |
| 1993 | 292 | 4.4 | -3.4 | 247 | 3.8 | 6.8 | 539 | 8.2 | 1.0 |
| 1994 | 282 | 4.1 | -3.5 | 259 | 3.7 | 4.9 | 541 | 7.8 | 0.4 |
| 1995 | 274 | 3.7 | -3.1 | 271 | 3.7 | 4.7 | 545 | 7.4 | 0.6 |
| 1996 | 266 | 3.5 | -2.8 | 267 | 3.5 | -1.7 | 533 | 6.9 | -2.2 |
| 1997 | 272 | 3.3 | 2.1 | 276 | 3.4 | 3.3 | 547 | 6.7 | 2.7 |
| 1998 | 270 | 3.1 | -0.5 | 282 | 3.3 | 2.3 | 552 | 6.4 | 0.9 |
| 1999 | 275 | 3.0 | 1.9 | 297 | 3.2 | 5.2 | 572 | 6.3 | 3.6 |
| 2000 | 295 | 3.0 | 7.1 | 320 | 3.3 | 7.9 | 615 | 6.3 | 7.5 |
| 2001 | 306 | 3.0 | 3.8 | 343 | 3.4 | 7.3 | 649 | 6.5 | 5.6 |
| 2002 | 349 | 3.4 | 14.0 | 385 | 3.7 | 12.3 | 734 | 7.1 | 13.1 |
| 2003 | 405 | 3.7 | 16.0 | 420 | 3.9 | 9.1 | 825 | 7.6 | 12.4 |
| 2004 | 454 | 3.9 | 12.1 | 441 | 3.8 | 4.9 | 895 | 7.7 | 8.4 |
| 2005[a] | 464 | 3.8 | 2.2 | 466 | 3.8 | 5.8 | 930 | 7.6 | 4.0 |

Sources: Office of Management and Budget for 1985 through 2004 and Congressional Budget Office for 2005.

a. Estimated. Excludes the effect on outlays of additional funding for operations in Iraq and Afghanistan, which has not yet been enacted for 2005.

assumptions, CBO projects that discretionary outlays for homeland security will average about 0.3 percent of GDP and about 1.5 percent of total federal spending over the next 10 years.

**Alternative Paths for Discretionary Spending.** As specified in the Deficit Control Act, CBO inflates discretionary budget authority (using the factors set forth in law) from the level appropriated in the current year to provide a reference point for assessing policy changes. CBO's baseline assumes that total budget authority in 2005 is about $840 billion and that obligation limitations total $45 billion, the amounts appropriated to date; both grow with inflation thereafter. Under those assumptions, discretionary funding would grow at an annual rate of about 2.4 percent for most of the projection period. Because funding can and probably will differ from those assumptions, CBO presents alternative paths for discretionary spending to show the budgetary consequences of using different rates of growth (see Table 3-10 on page 72).

The first alternative path assumes that funding will grow at the average annual rate of nominal GDP after 2005 (4.9 percent a year, or twice as fast as the rate of growth assumed in the baseline). Under this scenario, total discretionary outlays would exceed the baseline figures by $1.4 trillion over the projection period. Added debt-service costs would bring the cumulative increase in outlays to $1.7 trillion.

**Table 3-8.**

## Growth in Discretionary Budget Authority, 2004 to 2005

(Billions of dollars)

| | Actual 2004 | Estimated 2005 | Percentage Change |
|---|---|---|---|
| Budget Authority | | | |
| Defense | 486 | 421 | -13.3 |
| Nondefense | | | |
| Homeland security[a] | 27 | 31 | 14.3 |
| Other nondefense | 393 | 388 | -1.4 |
| Subtotal, nondefense | 420 | 419 | -0.3 |
| **Total** | **906** | **840** | **-7.3** |
| Budget Authority Excluding Supplementals[b] | | | |
| Defense | 394 | 420 | 6.7 |
| Nondefense | | | |
| Homeland security[a] | 27 | 31 | 14.7 |
| Other nondefense | 368 | 377 | 2.6 |
| Subtotal, nondefense | 395 | 409 | 3.5 |
| **Total Excluding Supplementals** | **789** | **829** | **5.1** |

Source: Congressional Budget Office.

a. CBO received some preliminary information from the Administration regarding the classification of appropriations for 2005 for the Department of Homeland Security. For homeland security activities outside of the department, CBO estimated homeland security spending for 2005 on the basis of the amounts designated for such activity in OMB's 2004 *Mid-Session Review.* Once the Administration releases its 2006 budget proposal in February 2005, CBO will revise its homeland security estimates to reflect the Administration's actual classification of those programs. About $9 billion of defense funding for 2004 and $11 billion of funding for 2005 is also classified as homeland security; those funds are shown in the defense category.

b. Supplemental appropriations in 2004 totaled $117 billion. Funding, primarily for activities in Iraq and Afghanistan, was contained in two acts. The first, enacted in November 2003, provided $87 billion. The second, the Department of Defense Appropriations Act, 2005, provided another $28 billion for 2004 (including $1.8 billion from reversing a rescission that had previously been enacted but not yet applied). In addition, $2 billion in supplemental funding for hurricane relief was provided in September 2004. Supplemental funding of $11.5 billion in 2005 has been provided for hurricane disaster assistance.

The second path assumes that discretionary resources are provided in 2005 and thereafter to continue activities in Iraq and Afghanistan and, more broadly, for the global war on terrorism. This policy alternative assumes an eventual slowdown of such activities and includes funding for domestic military operations for homeland security. Under that scenario, discretionary outlays over the 10-year period would total $418 billion more than the baseline figures presented in this report, and debt-service costs would increase by $172 billion.

The final path shows less spending: it assumes that most discretionary budget authority and obligation limitations are frozen throughout the projection period at the level provided in 2005. Total discretionary outlays for the 10-year period would be $1.1 trillion lower than those in the baseline scenario. Debt-service adjustments would reduce spending by another $0.2 trillion.

## Net Interest

In the next eight years, interest outlays will be one of the fastest growing components of the federal budget. CBO's baseline shows interest costs nearly doubling during this time, growing from $160 billion in 2004 to $314 billion in 2012; as a share of GDP, interest outlays are projected to total between 1.4 percent and 1.9 percent during that period (see Table 3-11 on page 74). By contrast, net interest as a share of the economy ranged from 2.0 percent

## Table 3-9.

# CBO's Baseline Projections of Discretionary Spending for Homeland Security

(Billions of dollars)

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Budget Authority | | | | | | | | | | | | | | |
| Defense | 9 | 11 | 11 | 11 | 12 | 12 | 12 | 13 | 13 | 13 | 14 | 14 | 58 | 124 |
| Nondefense[a] | | | | | | | | | | | | | | |
| Department of Homeland Security | | | | | | | | | | | | | | |
| Border and transportation security | 10 | 11 | 11 | 11 | 11 | 11 | 11 | 12 | 12 | 12 | 13 | 13 | 55 | 118 |
| Other activities | 9 | 11 | 8 | 9 | 9 | 11 | 9 | 9 | 10 | 10 | 10 | 10 | 46 | 95 |
| Subtotal, Department of Homeland Security | 19 | 21 | 19 | 20 | 20 | 22 | 21 | 21 | 22 | 22 | 23 | 23 | 101 | 213 |
| Other departments | 8 | 10 | 10 | 10 | 11 | 11 | 11 | 11 | 12 | 12 | 12 | 13 | 53 | 112 |
| Subtotal, nondefense | 27 | 31 | 29 | 30 | 30 | 33 | 32 | 33 | 33 | 34 | 35 | 36 | 154 | 326 |
| **Total Budget Authority** | **36** | **42** | **40** | **41** | **42** | **45** | **44** | **45** | **46** | **47** | **49** | **50** | **212** | **449** |
| Outlays | | | | | | | | | | | | | | |
| Defense | 9 | 11 | 11 | 11 | 11 | 12 | 12 | 12 | 13 | 13 | 13 | 14 | 57 | 122 |
| Nondefense[a] | | | | | | | | | | | | | | |
| Department of Homeland Security | | | | | | | | | | | | | | |
| Border and transportation security | 9 | 10 | 11 | 11 | 11 | 11 | 11 | 12 | 12 | 12 | 13 | 13 | 55 | 116 |
| Other activities | 5 | 7 | 9 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 10 | 48 | 97 |
| Subtotal, Department of Homeland Security | 15 | 17 | 19 | 20 | 21 | 21 | 21 | 21 | 22 | 22 | 23 | 23 | 102 | 214 |
| Other departments | 7 | 9 | 10 | 10 | 11 | 11 | 11 | 11 | 12 | 12 | 12 | 12 | 53 | 112 |
| Subtotal, nondefense | 21 | 26 | 29 | 31 | 31 | 31 | 32 | 33 | 33 | 34 | 35 | 36 | 155 | 325 |
| **Total Outlays** | **30** | **37** | **40** | **42** | **43** | **43** | **44** | **45** | **46** | **47** | **48** | **49** | **212** | **448** |
| **Memorandum:** | | | | | | | | | | | | | | |
| Mandatory Outlays for Homeland Security | 1 | * | * | * | * | * | * | * | * | * | * | 2 | 1 | 2 |

Source: Congressional Budget Office.

Notes: * = between -$500 million and $500 million.

CBO's classification of homeland security funding is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some activities of the department, such as disaster relief, are not included in the definition, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within the Administration's definition of homeland security. About half of all spending considered to be for homeland security is for activities outside of the Department of Homeland Security.

CBO received some preliminary information from the Administration regarding the classification of appropriations for 2005 for the Department of Homeland Security. For homeland security activities outside of the department, CBO estimated homeland security spending for 2005 on the basis of the amounts designated for such activity in OMB's 2004 *Mid-Session Review.* Once the Administration releases its 2006 budget proposal in February 2005, CBO will revise its homeland security estimates to reflect the Administration's actual classification of those programs.

The amounts shown in this table reflect the net spending for homeland security activities. About $4 billion to $5 billion a year in spending is offset by fees and other receipts.

a. Project BioShield, an initiative to expand the government's arsenal of counterbioterrorism agents, has received appropriations for 2005 and 2009. Budget authority for all other years is zero.

## Table 3-10.

# CBO's Projections of Discretionary Spending Under Alternative Paths

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Baseline (Discretionary Resources Grow with Inflation After 2005)[a]** | | | | | | | | | | | | | |
| Budget Authority | | | | | | | | | | | | | |
| Defense | 421 | 432 | 441 | 452 | 463 | 474 | 486 | 498 | 510 | 523 | 536 | 2,263 | 4,817 |
| Nondefense | 419 | 428 | 438 | 448 | 460 | 469 | 480 | 491 | 503 | 514 | 526 | 2,242 | 4,756 |
| **Total** | **840** | **859** | **879** | **900** | **923** | **943** | **966** | **989** | **1,013** | **1,038** | **1,063** | **4,505** | **9,573** |
| Outlays | | | | | | | | | | | | | |
| Defense | 464 | 438 | 435 | 447 | 457 | 468 | 484 | 488 | 504 | 516 | 529 | 2,245 | 4,765 |
| Nondefense | 466 | 476 | 485 | 493 | 502 | 511 | 523 | 534 | 546 | 559 | 572 | 2,468 | 5,202 |
| **Total** | **930** | **914** | **919** | **940** | **959** | **980** | **1,006** | **1,022** | **1,050** | **1,075** | **1,101** | **4,713** | **9,966** |
| **Discretionary Resources Grow at the Rate of Nominal GDP After 2005** | | | | | | | | | | | | | |
| Budget Authority | | | | | | | | | | | | | |
| Defense | 421 | 444 | 467 | 492 | 517 | 542 | 567 | 594 | 621 | 649 | 678 | 2,462 | 5,570 |
| Nondefense | 419 | 439 | 463 | 488 | 514 | 537 | 562 | 588 | 614 | 642 | 670 | 2,441 | 5,516 |
| **Total** | **840** | **883** | **931** | **980** | **1,031** | **1,078** | **1,129** | **1,181** | **1,235** | **1,291** | **1,348** | **4,903** | **11,087** |
| Outlays | | | | | | | | | | | | | |
| Defense | 464 | 446 | 455 | 481 | 504 | 529 | 558 | 576 | 606 | 634 | 663 | 2,415 | 5,452 |
| Nondefense | 466 | 483 | 505 | 528 | 552 | 577 | 604 | 632 | 660 | 690 | 721 | 2,645 | 5,951 |
| **Total** | **930** | **929** | **959** | **1,009** | **1,057** | **1,106** | **1,162** | **1,208** | **1,267** | **1,324** | **1,383** | **5,059** | **11,403** |
| **Appropriations Are Provided for Activities in Iraq and Afghanistan and for the Global War on Terrorism** | | | | | | | | | | | | | |
| Budget Authority | | | | | | | | | | | | | |
| Defense | 486 | 517 | 506 | 502 | 498 | 499 | 511 | 524 | 537 | 550 | 564 | 2,523 | 5,210 |
| Nondefense | 419 | 428 | 438 | 448 | 460 | 469 | 480 | 491 | 503 | 514 | 526 | 2,242 | 4,756 |
| **Total** | **905** | **944** | **944** | **950** | **958** | **968** | **991** | **1,015** | **1,040** | **1,065** | **1,091** | **4,765** | **9,966** |
| Outlays | | | | | | | | | | | | | |
| Defense | 494 | 508 | 510 | 512 | 502 | 498 | 509 | 514 | 531 | 543 | 557 | 2,530 | 5,183 |
| Nondefense | 466 | 476 | 485 | 493 | 502 | 511 | 523 | 534 | 546 | 559 | 572 | 2,468 | 5,202 |
| **Total** | **960** | **984** | **994** | **1,005** | **1,004** | **1,010** | **1,031** | **1,048** | **1,077** | **1,102** | **1,129** | **4,998** | **10,384** |

Continued

of GDP to 3.3 percent each year between 1981 and 2001. As a share of total outlays, interest costs are projected to rise from 7.0 percent in 2004 to 9.7 percent in 2012.

The increase in interest payments is attributable to accumulating debt as well as the rising interest rates in CBO's economic forecast. Assuming that certain tax provisions expire as specified in current law, net interest costs begin to decline after 2012 as deficits revert to surpluses under the baseline; by 2015, net interest costs are projected to total $303 billion, or 1.5 percent of GDP—the same percentage as in 2005.

Interest costs in 2005 will total $178 billion, CBO estimates, $17 billion more than in 2004. Most of that increase is attributable to recent action by the Federal Reserve to raise short-term rates and to expected future in-

**Table 3-10.**

## Continued

(Billions of dollars)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Discretionary Resources Are Frozen at the 2004 Level** | | | | | | | | | | | | | |
| Budget Authority | | | | | | | | | | | | | |
| Defense | 421 | 421 | 421 | 421 | 421 | 421 | 421 | 421 | 421 | 421 | 421 | 2,106 | 4,211 |
| Nondefense | 419 | 418 | 418 | 418 | 420 | 417 | 417 | 416 | 416 | 415 | 415 | 2,091 | 4,169 |
| **Total** | **840** | **839** | **839** | **839** | **841** | **838** | **838** | **837** | **837** | **836** | **836** | **4,196** | **8,381** |
| Outlays | | | | | | | | | | | | | |
| Defense | 464 | 430 | 418 | 420 | 420 | 420 | 423 | 416 | 420 | 420 | 420 | 2,108 | 4,205 |
| Nondefense | 466 | 470 | 470 | 468 | 466 | 463 | 462 | 462 | 461 | 461 | 460 | 2,336 | 4,643 |
| **Total** | **930** | **900** | **887** | **888** | **885** | **883** | **885** | **878** | **881** | **880** | **880** | **4,444** | **8,848** |
| **Memorandum:** | | | | | | | | | | | | | |
| Obligation Limitations in CBO's September 2004 Baseline | 45 | 46 | 47 | 48 | 49 | 49 | 50 | 51 | 52 | 53 | 54 | 239 | 500 |

Source: Congressional Budget Office.

Note: Discretionary resources include both budget authority and obligation limitations. Spending from the Highway Trust Fund and the Airport and Airway Trust Fund is subject to such limitations. Budget authority for those programs is provided in authorizing legislation and is not considered discretionary.

a. Using the inflators specified in the Deficit Control Act (the GDP deflator and the employment cost index for wages and salaries).

creases in those rates during the year. Increased borrowing requirements to finance recent deficits will also boost net interest outlays in 2005.

The federal government's interest payments depend primarily on the amount of outstanding debt held by the public and on interest rates. The Congress and the President can influence the former through legislation that governs spending and taxes and, thus, the extent of government borrowing. Interest rates are determined by market forces and the Federal Reserve's policies.

Interest outlays are also affected by the composition of debt held by the public. The average maturity of outstanding marketable debt has remained fairly constant since 1986, ranging from four years to six years. That stability, however, masks some changes in the types of securities issued by the Treasury Department. For example, in 2001, the Treasury stopped issuing 30-year bonds and introduced a four-week bill. As a result, the average maturity of outstanding debt has fallen from five and three-quarter years in December 2000 to about four and a half years in September 2004. Currently, Treasury bills with a maturity of six months or less account for about 25 percent of all marketable debt (a similar proportion is assumed to continue throughout the 10-year projection period). Although such securities generally carry lower interest rates, they are riskier obligations for the Treasury than securities with longer-term maturities because their financing costs are subject to rapid fluctuations in interest rates.

The federal government has issued about $3.1 trillion in securities to federal trust funds. Similar to the composition of debt held by the public, those securities consist of bills, notes, bonds, inflation-indexed securities, and zero-coupon bonds. However, the interest paid on those securities has no net budgetary impact because it is credited to accounts elsewhere in the budget. In 2005, trust funds will be credited with $161 billion in interest, CBO estimates—mostly for the Social Security and Civil Service Retirement trust funds.

The $6 billion in other interest that CBO anticipates the government will receive in 2005 represents the net of certain interest payments and interest collections. On bal-

## Table 3-11.

# CBO's Baseline Projections of Federal Interest Outlays

(Billions of dollars)

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Interest on Public Debt (Gross interest)[a] | 322 | 347 | 392 | 446 | 489 | 523 | 556 | 585 | 609 | 629 | 650 | 668 | 2,405 | 5,546 |
| Interest Received by Trust Funds | | | | | | | | | | | | | | |
| Social Security | -86 | -91 | -96 | -106 | -117 | -129 | -142 | -156 | -171 | -186 | -203 | -219 | -589 | -1,524 |
| Other trust funds[b] | -68 | -70 | -72 | -77 | -82 | -86 | -90 | -94 | -98 | -103 | -107 | -113 | -407 | -921 |
| Subtotal | -154 | -161 | -168 | -183 | -198 | -215 | -232 | -250 | -269 | -289 | -310 | -332 | -996 | -2,446 |
| Other Interest[c] | -4 | -6 | -10 | -13 | -15 | -18 | -20 | -23 | -25 | -28 | -31 | -33 | -76 | -215 |
| Other Investment Income[d] | -3 | -2 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -5 | -10 |
| **Total (Net interest)** | **160** | **178** | **213** | **249** | **274** | **289** | **303** | **311** | **314** | **311** | **308** | **303** | **1,328** | **2,875** |

Source: Congressional Budget Office.

a. Excludes interest costs of debt issued by agencies other than the Treasury (primarily the Tennessee Valley Authority).

b. Mainly the Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance trust funds.

c. Primarily interest on loans to the public.

d. Earnings on private investments by the National Railroad Retirement Investment Trust.

ance, the government earns more of such interest than it pays out. Among its interest expenses are payments for interest on tax refunds that are delayed for more than 45 days after the filing date. On the collections side, interest received from the financing accounts of credit programs, such as direct student loans, is one of the larger categories. Although other interest appears to increase rapidly through the projection period, almost all of that growth is attributable to interest on the accrued balances credited to the TRICARE For Life program. (Because those are considered intragovernmental payments, the net effect on interest outlays is zero.) In addition, CBO estimates that earnings from the Railroad Retirement Investment Trust in 2005 will total about $2 billion.